MISCELLANEOUS TAX BILLS

HEARINGS

BEFORE THE

SUBCOMMITTEE ON
SELECT REVENUE MEASURES

OF THE

COMMITTEE ON WAYS AND MEANS
HOUSE OF REPRESENTATIVES

NINETY-EIGHTH CONGRESS

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MISCELLANEOUS TAX BILLS

WEDNESDAY, SEPTEMBER 21, 1983

House of Representatives,
Committee on Ways and Means,
Subcommittee on Select Revenue Measures,
Washington, D.C.

The subcommittee met at 11 a.m., pursuant to notice, in room 1100, Longworth House Office Building, Hon. Fortney H. (Pete) Stark (chairman of the subcommittee) presiding.

Chairman Stark. The subcommittee will begin. Today we will hear testimony on eight bills. To give members maximum time to question witnesses, we are going to hold strictly to the 5-minute rule and we are going to ask the witnesses to summarize their testimony. Prepared statements will appear in full in the record of today's proceedings and I ask unanimous consent that the press release announcing today's hearing be made a part of the record, without objection.

[The press releases announcing the hearings follow:]

[Press Release No. 7, Thursday, Sept. 8, 1983]

The Honorable Fortney H. (Pete) Stark, (D., Calif.) Chairman, Subcommittee on Select Revenue Measures, Committee on Ways and Means, Announces a Public Hearing on Miscellaneous Tax Bills to be Held Wednesday, September 21, 1983

The Honorable Fortney H. (Pete) Stark, (D., Calif.) Chairman, Subcommittee on Select Revenue Measures, Committee on Ways and Means, U.S. House of Representatives, today announced a public hearing on miscellaneous tax bills to be held Wednesday, September 21, 1983, at 11:00 a.m. in the Committee's main hearing room, 1100 Longworth House Office Building.

The lead-off witness at the hearing is expected to be the Treasury Department. Testimony is invited on the following bills:

H.R. 699.—(Mr. Stark, Mr. Archer, Mr. Horton, Mr. Coughlin and Mr. Leland)—To amend the Internal Revenue Code of 1954 with respect to the tax treatment of certain conversions of residential rental property into condominium units.

H.R. 2476.—(Mr. Duncan of Tennessee, Mr. Boner of Tennessee, and Mr. Skelton)—To provide that no gain shall be recognized for purposes of the Internal Revenue Code of 1954 from any net gift made before March 4, 1981.

H.R. 2504.—(Mr. Schulze and Mr. Murtha)—To amend the Internal Revenue Code of 1954 to provide that gross income does not include interest on obligations issued by certain educational organizations.

H.R. 2831.—(Mr. Panetta)—To amend the Internal Revenue Code of 1954 to allow a disaster loss deduction with respect to a taxpayer's residence for losses which occur where the taxpayer is ordered to demolish or relocate such residence because of the danger of mudslides, earthslides, or flooding.

H.R. 3096.—(Mr. Stark)—To amend the Internal Revenue Code of 1954 to prevent certain abuses involving tax straddles and to prevent the avoidance of the accumulated earnings tax through the use of foreign corporations.

H.R. 3097.[1]—(Mr. Stark)—To amend the Internal Revenue Code of 1954 to provide that the operation of a lawyer referral service by a State or local bar association shall not be treated as an unrelated trade or business.

H.R. 3173.—(Mr. Matsui)—To amend the Internal Revenue Code of 1954 to provide for the application of cash or deferred arrangement rules to money purchase plans.

H.R. 3592.—(Mr. Rostenkowski and Mr. Conable)—To amend the Internal Revenue Code of 1954 to permit the rollover of certain partial distributions from qualified plans, and for other purposes.

H.R. 3593.—(Mr. Stark and Mr. Conable)—To amend the Internal Revenue Code of 1954 to allow the medical care deduction for lodging away from home in certain cases.

DETAILS FOR SUBMISSIONS OF REQUESTS TO BE HEARD

Individuals and organizations interested in presenting oral testimony before the Subcommittee must submit their requests to be heard by telephone to Harriett Lawler [(202) 225-3627] no later than noon, Thursday, September 15, 1983, to be followed by a formal written request to John J. Salmon, Chief Counsel, Committee on Ways and Means, U.S. House of Representatives, 1102 Longworth House Office Building, Washington, D.C. 20515. Notification to those scheduled to appear will be made by telephone as soon as possible after the filing deadline.

It is urged that persons and organizations having a common position make every effort to designate one spokesperson to represent them in order for the Subcommittee to hear as many points of view as possible. Time for oral presentations will be limited with the understanding that a more detailed statement may be included in the printed record of the hearing. This procedure will afford more time for members to question witnesses. In order to expedite the hearing, witnesses may be grouped as panelists with strict time limitations for each panelist.

Requests to be heard must contain the following information:

(1) The name, full address, and capacity in which the witness will appear (as well as a telephone number where he or his designated representative may be reached);

(2) A list of any clients or persons, or any organization for whom the witness appears; and

(3) A topical outline or summary of comments and recommendations.

The above information should also be incorporated in the prepared statements to be presented in person as well as those filed for the written record of the hearing.

In order to assure the most productive use of the limited amount of time available to question witnesses, witnesses scheduled to appear before the Subcommittee must comply with the following rules:

(1) All witnesses must submit 100 copies of their prepared statement to the full Committee office, Room 1102, Longworth House Office Building, not later than Noon, Monday, September 19, 1983.

(2) Witnesses should not read their written statements to the Subcommittee, but should instead limit their oral presentations to a summary of the points included in the statement.

(3) Not more than five minutes will be allowed for the oral summary.

The Subcommittee wishes to emphasize that failure to comply with these requirements may result in the witnesses being denied the opportunity to testify in person or being deferred until all other testimony is heard.

WRITTEN STATEMENTS IN LIEU OF PERSONAL APPEARANCE

For those who wish to file a written statement for the printed record of the hearing, five copies are required and may be submitted to John J. Salmon, Chief Counsel, Committee on Ways and Means, U.S. House of Representatives, Room 1102, Longworth House Office Building, Washington, D.C. 20515, by close of business, September 30, 1983. An additional supply of statements for the printed record may be furnished for distribution to the press and public if supplied to the Committee office before the hearing.

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[1] H.R. 3097 was subsequently withdrawn from consideration by the sponsor of the bill.

[Press Release No. 10, Thursday, Oct. 27, 1983]

THE HONORABLE FORTNEY H. (PETE) STARK, (D., CALIF.) CHAIRMAN, SUBCOMMITTEE ON SELECT REVENUE MEASURES, COMMITTEE ON WAYS AND MEANS, ANNOUNCES A PUBLIC HEARING ON MISCELLANEOUS TAX BILLS TO BE HELD THURSDAY, NOVEMBER 3, 1983

The Honorable Fortney H. (Pete) Stark, (D., Calif.), Chairman, Subcommittee on Select Revenue Measures, Committee on Ways and Means, U.S. House of Representatives, today announced a public hearing on miscellaneous tax bills to be held Thursday, November 3, 1983, at 1:00 p.m. in B-318 Rayburn Building.

The lead-off witness at the hearing is expected to be the Treasury Department. Testimony is invited on the following bills:

H.R. 677.—(Mr. Shannon, Mr. Conable, Mr. Duncan, Mr. Anthony, Mr. Frenzel, and others) To provide that Subtitles A and C of the Internal Revenue Code of 1954 shall be applied without regard to the value of lodging located in the proximity of an educational institution and furnished by such institution to its employees for taxable years or periods beginning before January 1, 1984.

H.R. 1607.—(Mr. Gibbons, Mr. Matsui, Mr. Jacobs, Mr. Vander Jagt, Mr. Anthony, Mr. Frenzel, Mr. Fowler, Mr. Shannon, Mr. Hance, Mr. Archer, Mr. Duncan, Mr. Flippo, Mr. Guarini, Mr. Gradison, Mr. Philip M. Crane, Mr. Ford of Tennessee, Mr. Martin of North Carolina, Mr. Campbell, and others) To amend the Internal Revenue Code of 1954 to make it clear that certain motor vehicle operating leases are leases.

H.R. 2568.—(Mr. Shannon, Mr. Frenzel, Mr. Matsui, Mr. Jenkins, Mr. Thomas of California, Mr. Rangel, and others) To amend the Internal Revenue Code of 1954 to repeal the provision which terminates the exclusion for amounts received under certain educational assistance programs.

H.R. 3030.—(Mr. Schulze) To amend the Revenue Act of 1978 to provide that the inclusion in gross income of certain amounts of unemployment compensation shall not apply to unemployment compensation which is payable by reason of a work stoppage in 1973 but which was not paid until 1979.

H.R. 3529.—(Mrs. Kennelly) To amend the Internal Revenue Code of 1954 with respect to the tax treatment of regulated investment companies.

DETAILS FOR SUBMISSION OF REQUESTS TO BE HEARD

Individuals and organizations interested in presenting oral testimony before the Subcommittee must submit their requests to be heard by telephone to Harriett Lawler ((202) 225-3627) no later than noon, Tuesday, November 1, 1983, to be followed by a formal written request to John J. Salmon, Chief Counsel, Committee on Ways and Means, U.S. House of Representatives, 1102 Longworth House Office Building, Washington, D.C. 20515. Notification to those scheduled to appear will be made by telephone as soon as possible after the filing deadline.

It is urged that persons and organizations having a common position make every effort to designate one spokesperson to represent them in order for the Subcommittee to hear as many points of view as possible. Time for oral presentations will be limited with the understanding that a more detailed statement may be included in the printed record of the hearing. This procedure will afford more time for members to question witnesses. In order to expedite the hearing, witnesses may be grouped as panelists with strict time limitations for each panelist.

Requests to be heard must contain the following information:

(1) The name, full address, and capacity in which the witness will appear (as well as a telephone number where he or his designated representative may be reached);

(2) A list of any clients or persons, or any organization for whom the witness appears; and

(3) A topical outline or summary of comments and recommendations.

The above information should also be incorporated in the prepared statements to be presented in person as well as those filed for the written record of the hearing.

In order to assure the most productive use of the limited amount of time available to question witnesses, witnesses scheduled to appear before the Subcommittee must comply with the following rules:

(1) All witnesses must submit 75 copies of their prepared statement to the full Committee office, Room 1102, Longworth House Office Building, not later than the close of business, Wednesday, November 2, 1983.

(2) Witnesses should not read their written statements to the Subcommittee, but should instead limit their oral presentations to a summary of the points included in the statement.

(3) Not more than five minutes will be allowed for the oral summary.

The Subcommittee wishes to emphasize that failure to comply with these requirements may result in the witnesses being denied the opportunity to testify in person, or being deferred until all other testimony is heard.

WRITTEN STATEMENTS IN LIEU OF PERSONAL APPEARANCE

For those who wish to file a written statement for the printed record of the hearing, five copies are required and may be submitted to John J. Salmon, Chief Counsel, Committee on Ways and Means, U.S. House of Representatives, Room 1102, Longworth House Office Building, Washington, D.C. 20515, by close of business, Friday, November 18, 1983. An additional supply of statements for the printed record may be furnished for distribution to the press and public if supplied to the Committee office before the hearing.

[Press Release No. 11, Wednesday, Nov. 2, 1983]

THE HONORABLE FORTNEY H. (PETE) STARK, (D., CALIF.), CHAIRMAN, SUBCOMMITTEE ON SELECT REVENUE MEASURES, COMMITTEE ON WAYS AND MEANS, ANNOUNCES THREE ADDITIONAL BILLS TO BE CONSIDERED AT A PUBLIC HEARING ON MISCELLANEOUS TAX BILLS TO BE HELD THURSDAY, NOVEMBER 3, 1983

The Honorable Fortney H. (Pete) Stark, (D., Calif.), Chairman, Subcommittee on Select Revenue Measures, Committee on Ways and Means, U.S. House of Representatives, today announced three additional bills for consideration during public hearings on miscellaneous tax bills to be held Thursday, November 3, 1983, at 1:00 p.m. in B-318 Rayburn Building (see Subcommittee Press Release #10).

Testimony will be taken on the following three additional bills:

H.R. 4206.—(Mr. Archer, Mr. Matsui, Mrs. Kennelly, Mr. Hance, Mr. Anthony, Mr. Martin of North Carolina, Mr. Ford of Tennessee, Mr. Frenzel, Mr. Thomas of California, Mr. Vander Jagt, Mr. Gradison, Mr. Jones of Oklahoma, Mr. Moore, Mr. Campbell, Mr. Conable, Mr. Schulze, Mr. Duncan, Mr. Philip M. Crane, Mr. Fowler, and Mr. Stark) To amend the Internal Revenue Code of 1954 to exempt from Federal income taxes members of the Armed Forces of the United States who die as a result of hostile action overseas.

H.R. 4253.—(Mr. Dorgan) To allow claims for credit or refund for transportation expenses incurred with respect to employment at the anti-ballistic missile site near Nekoma, North Dakota.

H.R. 4271.—(Mr. Rostenkowski) To amend the Internal Revenue Code of 1954 to increase the limitation on the deduction for business gifts from $25 to $100.

DETAILS FOR SUBMISSION OF REQUESTS TO BE HEARD

Individuals and organizations interested in presenting oral testimony before the Subcommittee must submit their requests to be heard by telephone to Harriett Lawler ((202) 225-3627) by 10 a.m., Thursday, November 3, 1983.

It is urged that persons and organizations having a common position make every effort to designate one spokesperson to represent them in order for the Subcommittee to hear as many points of view as possible. Time for oral presentations will be limited with the understanding that a more detailed statement may be included in the printed record of the hearing. This procedure will afford more time for members to question witnesses. In order to expedite the hearing, witnesses may be grouped as panelists with strict time limitations for each panelist.

Requests to be heard must contain the following information:

(1) The name, full address, and capacity in which the witness will appear (as well as a telephone number where he or his designated representative may be reached);

(2) A list of any clients or persons, or any organizations for whom the witness appears; and

(3) A topical outline or summary of comments and recommendations.

The above information should also be incorporated in the prepared statements to be presented in person as well as those filed for the written record of the hearing.

In order to assure the most productive use of the limited amount of time available to question witnesses, witnesses scheduled to appear before the Subcommittee must comply with the following rules:

(1) All witnesses must submit 75 copies of their prepared statement to the full Committee office, Room 1102, Longworth House Office Building, by Noon, Thursday, November 3, 1983.

(2) Witnesses should not read their written statements to the Subcommittee, but should instead limit their oral presentations to a summary of the points included in the statement.

(3) Not more than five minutes will be allowed for the oral summary.

The Subcommittee wishes to emphasize that failure to comply with these requirements may result in the witnesses being denied the opportunity to testify in person or being deferred until all other testimony is heard.

WRITTEN STATEMENTS IN LIEU OF PERSONAL APPEARANCE

For those who wish to file a written statement for the printed record of the hearing, five copies are required and may be submitted to John J. Salmon, Chief Counsel, Committee on Ways and Means, U.S. House of Representatives, Room 1102, Longworth House Office Building, Washington, D.C. 20515, by close of business, Friday, November 18, 1983. An additional supply of statements for the printed record may be furnished for distribution to the press and public if supplied to the Committee office before the hearing.

Chairman **Stark**. The Treasury is usually our first witness, but because of a scheduling conflict, we are privileged to hear from our colleague from California, Leon Panetta on a matter of grave importance to his district and many of our districts in the country.

Leon, why don't you proceed in any fashion you prefer?

STATEMENT OF HON. LEON E. PANETTA, A REPRESENTATIVE IN CONGRESS FROM THE STATE OF CALIFORNIA

Mr. **Panetta**. Thank you very much, Mr. Chairman, and I would ask that my statement be made part of the record and I will try to summarize it as best as possible.

The hearing you are holding is on the legislation that I have introduced, H.R. 2831, which is an effort to provide equitable tax treatment for taxpayers who are forced either to demolish or remove or be removed from their homes as a result of the area being declared unsafe pursuant to a disaster declaration by the President.

The problem specifically arose in my district as a result of the storms that took place in 1982, the result being a devastating slide in one area called Love Creek. The slide came down and actually demolished something like 20 to 25 homes and literally destroyed not only the homes but actually took lives as well.

Adjacent to the area was another area that consisted of about 29 homes. Because of their proximity to this slide, the Corps of Engineers was called in to look at that situation, because cracks were appearing in the area above these homes adjacent to the slide area.

The Corps of Engineers went in, determined that the area was unsafe, made a report to that effect to the county. The county, pursuant to its laws and the laws of the State of California, issued abatement orders to those homeowners which said remove or destroy your homes within a period of time.

When the homeowners in this area applied for casualty loss deductions, and asked for a determination from the IRS as to whether they would be eligible, the IRS made a strict interpretation that essentially said that although there was a disaster, although there was a slide, the fact that without actual damage to these homes—in other words, a crack in the home or actual damage to the home, they would not qualify for the casualty loss.

We had a number of hearings with the IRS. I think the IRS basically senses the inequity involved in this situation. The fact is you had a declaration, you had a disaster, you had a slide, and the Corps of Engineers declared the area unsafe. These homes were as good as a total loss. I am talking about homes in this area that were between $100,000, and $400,000 in valuation. One the declaration had come out from the county, that was it.

As a consequence of that inequity, I have introduced this legislation to try to correct it. It is very strict, it is very limited to the kind of situation that I just described. It requires that there be a disaster declaration by the President of the United States, that the taxpayer is ordered by the government of the State or a political subdivision in which the residence is located to demolish or relocate such residences and that the order is based on a determination that there is danger of mud slide, earth slides, or flooding, and that any loss can then be submitted under the casualty loss provision.

I am just asking for simple equity. I think IRS admits it is important to implement the thrust of this kind of legislation, to correct this inequity, and so I would ask for your support on this legislation.

[The prepared statement follows:]

STATEMENT OF HON. LEON E. PANETTA, A REPRESENTATIVE IN CONGRESS FROM THE STATE OF CALIFORNIA

Mr. Chairman and members of the Subcommittee, first of all let me thank you for holding this hearing today in review of my legislation, H.R. 2831, to provide equitable tax treatment for taxpayers who are forced to either demolish, remove, or be removed from their homes because the area is declared unsafe. Mr. Chairman, very briefly, let me discuss with you the events which warrant this legislation to ensure that equal tax treatment is available in instances of this nature.

As you may recall, in January of 1982 a tremendous storm hit the central coastal area of Califronia, causing millions of dollars in property damages and the loss of nine lives in my area alone. The heavy rainfall caused major flooding and slide activity in the Love Creek area of Santa Cruz County, California leaving many area families homeless. For 29 families in particular, their experience was even more tragic.

Following the disaster and the issuance of a disaster declaration by President Reagan, the Army Corps of Engineers performed a full analysis of the Love Creek area and adjacent areas where slide activity occurred to determine the degree of safety in this area. The Corps concluded in its report that the Love Creek area was unsafe because of its close location to the area where actual slide activity occurred. Furthermore, it was concluded that there was a strong likelihood of further slide activity endagnering these homes. Following this study, the Santa Cruz County Board of Supervisors exercising provisions in its uniform code issued abatement notices requiring residents in Love Creek to abandon or remove their homes.

Mr. Chairman, we can only imagine the sadness and devastation which would accompany such a tragic order. Even though no physical damage took place, the disastrous results of the storms left the homes in this area virtually worthless. Beforehand, the value of homes in this area ranged from $100,000 to more than $400,000.

In the aftermath of the disaster, a request was submitted to the Internal Revenue Service seeking a determination of whether affected residents in the Love Creek area would be eligible for deductions for the losses they experienced. The Internal Revenue Service, in responding to this request, concluded that under its interpretation of current regulations the affected residents are not entitled to a casualty loss deduction in this situation. The IRS indicated that this decision was reached because of the lack of a proximate relationship between the occurence of the disaster and the losses sustained by residents resulting from the abatement order issued by the county. At this point in the record, I request the inclusion of a copy of the IRS opinion. In a follow-up meeting with IRS officials, the points in the opinion were again restated.

Mr. Chairman, the fact is that if these residents would have suffered any actual physical damage to their homes, they would be eligible for a casualty loss deduction. It is obvious that regardless of actual physical damage, the economic damage to the affected taxpayers related to the disaster is the equivalent loss.

An interesting fact concerning this case, which the IRS opinion references, is that in the case, Stower's v. U.S., 169 F. Supp. 246 (S.D., Miss. 1958) the court held that the taxpayer sustained a deductible casualty loss, despite the absence of any physical damage. There is therefore no legal precedent for maintaining such a rigid interpretation of IRS regulations. It is my strong feeling that in such situations, residents should not be prevented from applying for a deduction for losses caused by the unsafe conditions perpetrated by the impact of the natural disaster.

In view of the situation which I have described, I introduced H.R. 2831 seeking to provide equitable tax treatment for the residents affected by the IRS ruling. In summary, my legislation would allow a homeowner who resides in an area which has been declared a federal disaster area by the President, and is ordered to abandon, removal or be removed from their residence because of the danger of mudslides, earthslide, or flooding, should receive reductions for losses they sustained. This legislation would apply to taxable years beginning after December 31, 1981. This legislation is very limited in its scope and does not open-up the doors of the Treasury to an onslaught of amended tax returns seeking deductions for casualty losses. At present, I am aware of only 29 homeowners who may be eligible to utilize provisions of this legislation in seeking a deduction for casualty losses. This legislation has been tightly drafted as I think it should be, but I think it does allow for residents who encounter such unique experiences as occurred in my area to receive fair and equitable tax treatment.

Mr. Chairman, the situation which has developed in Love Creek has proven to be a test case for federal disaster programs in many areas. To date, the unique circumstances which are evident in this area have prevented legitimate relief to those suffering from disaster. This relief should not be prevented on a technical interpretation where the loss from the disaster is the same as if the home were totally destroyed. Therefore, appropriate changes are necessary to meet the unique situation which has occurred in the Love Creek area. I am hopeful that federal policies can be modified to address these needs.

In conclusion, I urge the subcommittee to take a careful look at the incident which occurred in my area, and give its approval to H.R. 2831. This legislation is warranted because it recognizes the unique developments which brought major devastation to 29 residents of my area. Moreover, in this situation simple fairness demands an avenue of relief.

Thank you for providing me with this opportunity to testify, and again, I urge the subcommittee to approve this measure to forward it on to the full committee.

Chairman STARK. Thank you very much.

A couple of questions. Let me see if I understand this. Let's assume for a minute that these homes were across the street from each other or side by side. One house fell down——

Mr. PANETTA. Totally destroyed.

Chairman STARK. So insurance would cover it, or if it didn't there would be a deductible allowance?

Mr. PANETTA. That is correct.

Chairman STARK. The house next door was uninhabitable, and it caused not only a risk to the occupants but could conceivably cause a risk to the general public or somebody down below, so it was ordered to be demolished and there was nothing that the occupant could do except watch the home be destroyed really as a result of the same earthquake?

Mr. PANETTA. That is right.

Chairman STARK. They weren't lucky enough to have theirs fall off the cliff, theirs had to be pushed the rest of the way over?

Mr. PANETTA. Yes, sir.

Chairman STARK. As the gentleman has explained it to me, the equity seems quite clearly on the side of his bill. What happens if the same situation arose as a result of an earthquake, which in California is a grave concern to us, would this apply? Let's assume that the Earth opened up and one home fell through the crack and the next one sat on the edge?

Mr. **Panetta**. In fact, the requirements here are that the area has to be determined by the President of the United States to be a disaster area and there has to be a declaration. Then there has to be an action by the State pursuant to that. The order is based on determination there is a danger of mud slide, earth slides or flooding. I would assume that could also result as a consequence of earthquakes.

Chairman **Stark**. I happen to think the gentleman makes a good case. I think it would apply to many other areas of the country. I know recently—I guess in the Galveston area of Texas—there was tremendous destruction because of either rain or storms.

I appreciate his coming here.

Mr. Duncan?

Mr. **Duncan**. I have no questions, thank you.

Chairman **Stark**. Mr. Schulze.

Mr. **Vander Jagt**. I have one question. I commend our colleague for making his case with such clarity and brevity, to address a situation that I think does cry out for equity. I do have one question.

Either the homes were demolished or removed or people were removed from the homes because of the threat. Now, how about a $100,000 home that at one time was worthless because they had to be removed from it, then conditions stabilize and they move back in and over the next few years the home becomes worth $100,000 again. Would they also be entitled to the deduction?

Mr. **Panetta**. I would assume that the IRS would make a determination in that instance that the loss did not take place. I would assume whatever regulations are implemented pursuant to this legislation would provide that the homeowner not benefit, obviously.

Mr. **Vander Jagt**. Judging by the past performance of the IRS in this case you would be certain——

Mr. **Panetta**. Yes, sir.

Chairman **Stark**. I think it is the intention that the home actually is demolished and that it has to be destroyed as it were, because of the threat to life, limb, or property.

Mr. **Vander Jagt**. I agree with our colleague. I am sure they would handle that in their regulations. The concern is that the wording provides that this would occur where the homes were demolished or the homes were removed or people were removed from the homes and that gives rise to the question.

Chairman **Stark**. I appreciate the gentleman's comment.

Thank you very much.

Mr. **Panetta**. Thank you very much.

Chairman **Stark**. Our next witness is Mr. Robert Woodward, tax legislative counsel for the Department of the Treasury.

As always, Mr. Woodward, we look forward to the administration's comments and evaluation and constructive criticism, and in your case, as I believe you are going to summarize each bill, you will be exempt from the 5-minute limit, as is our tradition. Proceed in any manner you are comfortable.

STATEMENT OF ROBERT G. WOODWARD, TAX LEGISLATIVE COUNSEL, DEPARTMENT OF THE TREASURY

Mr. **Woodward**. Thank you.

I am pleased to present the views of the Treasury Department on the bills before your subcommittee this morning.

The first bill is H.R. 699, which would add new section 1257 to the code relating to the tax treatment of certain conversions of residential rental property into condominium units. Although we believe that the tax treatment sought by H.R. 699 has some theoretical merit, we have substantial practical concerns with this proposal that require us to oppose the bill.

Under H.R. 699, a taxpayer who has owned residential rental property for 5 years or more and converts the property into condominium units could elect "dual" tax treatment for the gain that results from the taxpayer's sale of the units. Gain which is attributable to the preconversion appreciation of a unit would be treated as capital gain. If there were no such gain the provision would not apply. Any additional gain would be considered as resulting from the development and selling activities of the taxpayer and would be treated as ordinary income. Gain would be recognized proportionately upon the sale of each unit. Selling expenses and improvements made to units in anticipation of conversion and sale would offset only the ordinary income portion of the gain.

The stated objective of the sponsors of H.R. 699 is to reduce the cost of condominium units for prospective buyers, particularly existing tenants of converted properties, by changing the current tax rules that may encourage property owners to sell residential rental properties to middlemen/converters before the conversion. Under current law, the character of gain from the disposition of property is determined by the purpose for which the taxpayer holds the property at the time of disposition. This is true when a taxpayer's purpose for holding property changes prior to the sale, even though the accrued gain or loss at the time of the change of purpose would, if the property were disposed of at that time, be of a different character than subsequently occurring gain or loss.

Based on existing law, it is virtually certain that if the owner of residential rental property converts the property into condominium units and sells the units, all of the profits, including any preconversion appreciation in value, will constitute ordinary income. To avoid this result, the property owner sometimes will choose to sell the property to a middleman/converter. By so doing, the property owner locks in capital gain treatment on the preconversion appreciation in the property but foregoes the significant additional profits that may result from the conversion, improvement, and sale of the individual units.

It is our impression, however, that an increasing number of property owners are rejecting the middleman/converter route and instead are turning to more aggressive and sophisticated tax planning techniques that provide them with an opportunity to participate in the development and selling profits without sacrificing capital gain treatment for the preconversion appreciation.

One such technique is for the property owner to sell the property to a related entity such as a corporation or a partnership what will develop and sell the individual units. This technique is sometimes attacked by the Internal Revenue Service on the grounds that the transaction constitutes a disguised capital contribution to the corporation or partnership or, in the case of transfers to a corporation, is otherwise subject to section 351 of the code. When this attack is successful, the related entity takes a carryover basis in the property, increased by any gain recognized by the original owner on the recharacterized transfer, and the entity's entire gain is taxed at ordinary income rates when it sells the units.

Chairman **Stark**. You already get into the question of having to value the property as a rental unit?

Mr. **Woodward**. That is correct. It is in the context of whether these transactions are to be respected as they are structured by the taxpayers. I think though there is a very useful tension in current law relating to valuation. There are cases holding that taxpayers do get capital gain even if the sale is to a related entity, where the valuation is fair, where the terms of the sale have substantiality. The taxpayers on the other hand who have played the pig, so to speak, have gone to market.

Chairman **Stark**. If I can interrupt one time further. In fact, you find the right value on the sale as residential property and capital gains is collected on that, and then you collect the proper amount of ordinary income through the profits from conversion. This bill won't change the revenue to the Treasury in theory as between the person selling it to a converter, receiving capital gain and the converter paying ordinary income on the difference, there should be no difference?

Mr. **Woodward**. Yes, sir, Mr. Chairman, but I think that the words "in theory" should be heavily emphasized, and that is the reason that we acknowledge that the bill does have theoretical merit. But we have had experience under current law with a similar provision relating to the tax consequences on the cutting of timber. There is a special rule relating to timber cutting under section 631(a) of the code which you are familiar with. It allows the taxpayer to elect to treat the cutting as a sale, taking a capital gain on the appreciation in value up to that point and taking a stepped-up basis in the property for purposes of computing additional income on the selling of logs or use of the timber in producing paper or other products for sale.

In these cases, valuation is more often than not a disputed issue. The Service frequently finds that taxpayers claim unrealistically high values on cut timber. We certainly see similar problems manifest in this proposal. Indeed, we think that this proposal creates an even greater incentive to overstate the preconversion value of the property than exists in the case of timber.

Section 631(a) requires the taxpayer to recognize capital gain upon cutting of the timber, even though the timber may not be sold that year. In contrast, H.R. 699 would allow the taxpayer to defer recognition of the capital gain portion of his profit until the condominium units are sold.

In conclusion, while we acknowledge that the dual tax treatment sought by H.R. 699 may be supportable in theory, we must oppose the bill in view of the potential abuses and the administrative and judicial burdens that would result from relying on subjective taxpayer judgments to determine whether profits from condominium unit sales should be reported as capital gain or ordinary income.

Before leaving the subject of condominium conversions, we would like to bring to this subcommittee's attention a particularly troublesome tax planning technique sometimes employed in such conversions. This is spelled out in our written statement. In some cases, a corporation is employed to acquire, develop, and sell the condominium property. After the corporation has sold approximately one-third of the units, assuming all units are of equal value, but more than 1 year after the taxpayer has held his stock in the corporation, the corporation is liquidated and the taxpayer/shareholder claims capital gain treatment on the proceeds of the liquidation, including the fair market value of units received by him that have appreciated due to the corporation's conversion, development, and promotional activities.

Assuming the maximum individual and corporate tax rates, the parties combined effective tax rate on the profits attributable to the development and sales related activities will be approximately 32 percent, instead of the normal 50 percent rate for such profits. Even greater overall rate reductions may be available if the corporation maximizes its use of the graduated corporate tax rates, particularly by spreading its sales of one-third of the units over 2 taxable years, or if the corporation has multiple but separately identifiable properties. The collapsible corporation rules contained in code section 341, which were enacted to deal with situations of this type, would not prohibit this planning technique. We recommend that consideration be given to making discrete amendments to code section 341 to preclude the use of this abusive technique.

The next bill I will discuss is H.R. 2476, which would provide retroactive relief from a 1983 Supreme Court decision holding that the Federal gift tax liability assumed by the donee in a "net gift" transaction is an "amount realized" by the donor for income tax purposes. Treasury opposes this bill.

Mr. Chairman, in the interest of time—we have a number of bills—and since the basis for our objection on this bill is fully explained in our written statement, I won't go into detail why we oppose this proposal to make a retroactive change to reverse the Supreme Court case.

The next bill is H.R. 2504, which would amend code section 103 to provide that gross income does not include interest on obligations of a "qualified educational organization." A qualified educational organization is a college or university that was created by a special act of a State legislature and that is a "land grant college" under the Morrill Act. We understand that the primary beneficiary of H.R. 2504 is intended to be Pennsylvania State University. The bill has a retroactive effect date designed to confer tax exempt status on certain outstanding obligations of Pennsylvania State University that the Internal Revenue Service has determined to be taxable. Treasury opposes H.R. 2504.

Code section 103 provides the authority for State and local governments or instrumentalities acting on their behalf, to issue tax-exempt bonds, including bonds that finance public projects such as roads, sewers, and prisons, as well as bonds that finance certain qualifying activities which directly benefit private persons, including industrial development bonds, student loan bonds, and mortgage subsidy bonds.

Only specified types of entities are entitled to be issuers of tax-exempt bonds. States and their political subdivisions are qualified issuers of tax-exempt bonds. Longstanding Treasury regulations have extended the tax-exempt borrowing privilege to include constituted authorities, known as on behalf of issuers, empowered to issue obligations on behalf of States or their political subdivisions. In general, States, their political subdivisions, and on behalf of issuers are the only types of issuers of tax-exempt bonds under present law. There is a limited exception for qualified scholarship funding bonds, which may be issued by certain nonprofit corporations organized at the request of a State or one of its political subdivisions for the purpose of acquiring student loan notes.

Other persons, including private entities, often are able to receive the benefit of the tax-exempt borrowing privilege, but only if they can induce a qualified issuing entity to issue tax-exempt bonds for their benefit. Nevertheless, the ultimate responsibility rests on qualified issuers of tax-exempt bonds to determine if a project has a sufficient public purpose to warrant financing with tax-exempt bonds. Because of the importance of this function, the tax-exempt borrowing privilege generally has been limited to entities that are truly public and governmental in nature.

There is a long history in the development of law concerning the types of entities that are entitled to the tax-exempt borrowing privilege. In general the decided cases involve the definition of what is a political subdivision of a State. This is determined by whether the entity has one of the three sovereign powers that have been recognized as powers of States, that is, the power to tax, the power of eminent domain and police power.

One of those powers is enough under current law. The Court of Appeals for the Third Circuit in a recent decision in the case called *Philadelphia National Bank,* which involved Temple University, held that the power of a State-supported university to receive appropriations from the State legislature out of funds derived from tax revenues does not give the university the power to tax. That court also held that the right to maintain a campus police force having limited oncampus powers does not give the university substantial police powers.

There is another category of tax-exempt bond issuer, the "on behalf of" issuer, which may be established to carry out a public purpose for a political subdivision where there is sufficient connection with the subdivision that the on behalf of issuer can be viewed as the subdivision's alter ego.

For example, in the *Philadelphia National Bank* case, the court described an "on behalf of" issuer as one that is wholly governmentally controlled and that performs a wholly governmental function. The court looked to whether there was an identity of interest, control or intent between the political subdivision and the purported on behalf of issuer. Thus, the political subdivision and on behalf of requirements serve the beneficial purpose of limiting the tax-exempt borrowing privilege to entities that are fully subject to political control and are accountable for their actions at the State and local government level.

Congress recently has confirmed the importance of political control over and accountability for the exercise of the tax-exempt borrowing privilege. In the Tax Equity and Fiscal Responsibility Act of 1982, Congress enacted a public approval requirement applicable to all tax-exempt industrial development bonds. This requirement prohibits issuance of such bonds unless they have been approved by elected officials after a public hearing, or by a voter referendum. This public approval requirement is designed to insure that a valid public purpose is served by the bond issue.

H.R. 2504 would move in the opposite direction from the TEFRA reform by allowing the issuance of tax-exempt bonds by land-grant colleges that cannot meet either the political subdivision or the on behalf of tests of current law. Thus, in the case of obligations issued by Pennsylvania State University, the tax exemption would be available even though the State does not control a majority of the governing board of the university and has not granted to the university any substantial governmental powers.

We question the wisdom of granting the tax-exempt borrowing privilege to entities that are not subject to complete control by the political process. Furthermore, there is nothing in the Federal statutory provisions applicable to land-grant colleges insuring that they are wholly controlled instrumentalities of the States, or that they possess any substantial governmental powers. Thus, status as a land-grant college appears to be irrelevant to the question of whether a university should be an eligible issuer of tax-exempt bonds.

Denying the tax exemption for obligations issued by institutions such as Pennsylvania State University does not work any unfair hardship on them. If an expenditure by the university indeed serves a valid public purpose, the university is free to ask the State or one of its political subdivisions to issue tax-exempt bonds for that purpose. If the university desires to avoid the public scrutiny that this may entail, it is reasonable to question whether its borrowings in fact serve a public purpose sufficient to justify the tax exemption. Furthermore, if the Pennsylvania Legislature views the university as a true governmental body——

Mr. SCHULZE. I somewhat resent the use of the words "avoid public scrutiny" because that implies that there is an attempt to do that, and there is absolutely no attempt to do it. I object to the language because it seems you are putting an aspect there that has no place in this argument and I just want to make that point. You can make the argument without implying that they are trying to hide something.

Mr. WOODWARD. Mr. Schulze, you are absolutely correct, and I do not intend any such inference. I talk about this in a generic sense. The recent effort has been to try to control the issuance of tax-exempt bonds for nontraditional purposes, that is, purposes other than the more traditional municipal purposes which have provided the basis for the tax exemption in the past. The point is that there are means to go through under current law that would permit access to the tax-exempt borrowing privilege by these institutions, and we think that this is sufficient access to the tax-exempt borrowing privilege.

On that basis, we oppose this proposal.

The next bill is H.R. 2831, which would amend code section 165 to provide that a loss in connection with a residence located in a disaster area will be treated as a deductible disaster loss under code section 165 if the taxpayer is ordered by a State or local government to demolish or relocate the residence because of a danger of mudslides, earthslides, or flooding. The order must be issued within 120 days after the area is determined by the President to warrant assistance by the Federal Government under the Disaster Relief Act of 1974.

H.R. 2831 would be effective retroactively to taxable years beginning after December 3, 1981. The retroactive effective date is intended to benefit certain taxpayers who have been denied casualty loss deductions under an administrative determination by the Internal Revenue Service.

In general, Treasury does not oppose the thrust of the substantive provisions of H.R. 2831, although we believe that certain limitations should be added. We have discussed those limitations in the written statement. We have some concern that the revenue cost of the bill might be substantial, however we have not yet completed our estimate.

Finally, we feel we must oppose the retroactive effective date of the bill.

The next bill is H.R. 3096, which deals with two problems with current tax law which allow taxpayers to claim unintended tax benefits. Treasury strongly supports this bill. My written statement points out one technical comment on the proposed amendment that would be made to section 1092.

The next bill is H.R. 3173, which would extend to salary reduction money purchase pension plans in existence on June 27, 1974, the rules applicable to cash or deferred arrangements under qualified profit-sharing or stock bonus plans. Treasury supports H.R. 3173.

Treasury testified in support of this proposal in the last Congress and we continue to support the bill. Our written statement contains a detailed discussion of the background of the bill. We also point out some remaining problems in the salary reduction area which may merit the subcommittee's attention.

The next bill is H.R 3592, which would make a number of changes in various provisions of the Internal Revenue Code. Section 2 of the bill would allow tax-free rollovers to individual retirement accounts for certain partial distributions from qualified plans.

Treasury supports this change. The proposal would promote savings for retirement and simplify one of the more complex areas of the tax law. Tax-free rollover of large partial distributions also would enable the recipient to avoid the relatively harsh tax consequences applicable to partial as opposed to lump sum distributions. Our written statement discusses this proposal in detail.

Sections 3 and 4 of the bill would amend the expense and loss disallowance rules applicable to transactions between related parties under section 267 of the code.

Treasury strongly supports these sections of the bill. We discuss these changes in detail in our written statement and make certain technical suggestions relating to the proposed changes.

Section 5 of the bill would extend to preferred stock investments the special ordinary loss treatment currently provided by code section 1244 for qualifying common stock investments.

Treasury opposes this change. We believe that existing law is correct in limiting the special ordinary loss treatment of section 1244 to common stock investments which are more risky than preferred stock investments. We think there is a valid reason for maintaining that limitation in the interest of encouraging investments in these qualifying corporations in the form of common stock rather than preferred stock.

The next amendment that would be made in H.R. 3592 is in section 6 of the bill, which is a technical clarification to section 103 of the code to remove an uncertainty that has been created concerning the status of section 103(m) of the code. We fully support this clarification.

The final bill is H.R. 3593, which would amend the medical expense deduction provision in section 213 of the code to allow the deduction of certain amounts paid for lodging while away from home primarily for medical care. While Treasury is sympathetic with the objectives of H.R. 3593, we cannot support the bill in its present form because we believe that it would create significant possibilities for abuse, and because it would not be administrable by the Internal Revenue Service. Our written statement discusses our concerns at some length.

Treasury would be happy to work with the subcommittee in attempting to fashion an amendment that is better targeted to those who deserve relief with respect to away-from-home travel for medical purposes.

In our written statement we make some specific suggestions for possible amendments to the bill that would address our concerns regarding possible abuses.

This concludes my prepared remarks. I would be happy to respond to your questions.

[The prepared statement follows:]

STATEMENT OF ROBERT G. WOODWARD, TAX LEGISLATIVE COUNSEL, DEPARTMENT OF THE TREASURY

Mr. Chairman and Members of the Subcommittee: I am pleased to present the views of the Treasury Department on the following tax bills:

H.R. 699, which would provide special capital gains treatment for certain condominium conversions;

H.R. 2476, which would retroactively exempt from tax the gain realized in certain net gift transactions;

H.R. 2504, which would provide tax-exempt status for obligations issued by land grant colleges;

H.R. 2831, which would allow disaster loss treatment of losses on demolition or relocation of residences in certain cases;

H.R. 3096, which deals with attempts to circumvent the tax straddle and accumulated earnings tax restrictions through the use of foreign corporations;

H.R. 3173, which would extend the cash or deferrred plan rules to salary reduction arrangements under money purchase pension plans;

H.R. 3592, which would permit the rollover to individual retirement accounts of certain partial distributions from qualified plans, would amend the expense and loss disallowance rules of section 267 of the Internal Revenue Code, would provide ordinary loss treatment for preferred stock under section 1244, and would make a technical clarification to section 103; and

H.R. 3593, which would allow the deduction of certain amounts paid for lodging while away from home primarily for out-patient medical care.

I will discuss each of these bills in turn.

H.R. 699—CAPITAL GAIN TREATMENT FOR CERTAIN CONDOMINIUM CONVERSIONS

H.R. 699 would add new section 1257 to the Code relating to the tax treatment of certain conversions of residential rental property into condominium units. Although we believe that the tax treatment sought by H.R. 699 has some theoretical merit, we have substantial practical concerns with this proposal that require us to oppose the bill.

Under H.R. 699, a taxpayer that has owned residential rental property for 5 years or more and converts the property into condominium units could elect "dual" tax treatment for the gain that results from the taxpayer's sale of the units. Gain which is attributable to the pre-conversion appreciation of a unit would be treated as capital gain. If there were no such gain the provision would not apply. Any additional gain would be considered as resulting from the development and selling activities of the taxpayer and would be treated as ordinary income. Gain would be recognized proportionately upon the sale of each unit. Selling expenses and improvements made to units in anticipation of conversion and sale would offset only the ordinary income portion of the gain.

The stated objective of the sponsors of H.R. 699 is to reduce the cost of condominium units for prospective buyers (particularly existing tenants of converted properties) by changing the current tax rules that may encourage property owners to sell residential rental properties to middlemen/converters before the conversion. Under current law, the character of gain from the disposition of property is determined by the purpose for which the taxpayer holds the property at the time of disposition. This is true when a taxpayer's purpose for holding property changes prior to the sale, even though the accrued gain or loss at the time of the change of purpose would, if the property were disposed of at that time, be of a different character than subsequently accruing gain or loss.

Based on existing law, it is virtually certain that if the owner of residential rental property converts the property into condominium units and sells the units, all of the profits—including any pre-conversion appreciation in value—will constitute ordinary income. To avoid this result, the property owner sometimes will choose to sell the property to a middleman/converter. By so doing, the property owner locks in capital gain treatment on the pre-conversion appreciation in the property but foregoes the significant additional profits that may result from the conversion, improvement, and sale of the individual units.

It is our impression, however, that an increasing number of property owners are rejecting the middleman/converter route and instead are turning to more aggressive and sophisticated tax planning techniques that provide them with an opportunity to participate in the development and selling profits without sacrificing capital gain treatment for the pre-conversion appreciation. One such technique is for the property owner to sell the property to a related entity such as a corporation or a partnership that will develop and sell the individual units. This technique is sometimes attacked by the Internal Revenue Service on the grounds that the transaction constitutes a disguised capital contribution to the corporation or partnership or, in the case of transfers to a corporation, is otherwise subject to section 351 of the Code. When this attack is successful, the related entity takes a carryover basis in property (increased by any gain recognized by the original owner on the recharacterized transfer) and the entity's entire gain is taxed at ordinary income rates when it sells the units.

Alternatively, the Service may assert that the development and selling activities of the entity should be imputed to the original property owner or that the change of purpose for holding the property occurred before it was sold to the entity. When either of these arguments is successful, the original property owner's gain on the sale to the entity is recognized but is recharacterized as ordinary income. The Service also may attempt to achieve that result by arguing that the transaction constitutes a joint venture between the original property owner and the related entity or, on sales of depreciable real property, by applying section 1239 of the Code.

Experience under current law shows that in a sale between related parties, the closing date and selling price set by the parties cannot be relied upon to draw the line between capital gain and development-related ordinary income. The attention given these transactions by the Service and the courts stems from concern over delayed closings and inflated selling prices as means of converting potential ordinary income of the developing entity into additional capital gain for the original owner. This same concern requires us to oppose H.R. 699, since it would permit property owners to convert development-related profits into capital gain by claiming inflated values for property at the time of "conversion." The timing and valuation problems which are implicit in the cases involving sales to related entities would be explicit under the dual tax treatment approach of H.R. 699. The level of tax avoidance and controversy in this area would continue, if not increase.

Our valuation concern is borne out by actual experience with an existing Code provision that provides for dual tax treatment under a special election similar to the one contemplated by H.R. 699. Under section 631(a) of the Code, a taxpayer may elect to treat the cutting of timber as a sale. This allows the taxpayer to recognize capital gain to the entent the value of the timber on the first day of the taxable year of cutting exceeds the taxpayer's adjusted basis in the timber. That value is thereafter treated as the taxpayer's basis in the timber. Upon subsequent disposition of the timber, ordinary income or loss is computed with reference to that new basis. Valuation is more often than not a disputed issue in cases where the taxpayer elects to use section 631(a). The Service frequently finds that taxpayers claim unrealistically high values for cut timber to maximize the capital gain portion of their total profits.

Under H.R. 699, there would be even greater incentive to overstate the pre-conversion value of the property than exists in the case of timber. Section 631(a) requires the taxpayer to recognize capital gain upon cutting of the timber, even though the timber may not be sold that year. In contrast, H.R. 699 would allow the taxpayer to defer recognition of the capital gain portion of this profit until the condominium units are sold.

In conclusion, while we acknowledge that the dual tax treatment sought by H.R. 699 may be supportable in theory, we must oppose the bill in view of the potential abuses and the administrative and judicial burdens that would result from relying on subjective taxpayer judgments to determine whether profits from condominium unit sales should be reported as capital gain or ordinary income.

Before leaving the subject of condominium conversions, we would like to bring to this Subcommittee's attention a particularly troublesome tax planning technique sometimes employed in such conversions. Under one variation of this technique, the property to be converted is sold to the taxpayer's wholly owned corporation which undertakes the conversion and improvement of the property and commences sale of the individual units. After the corporation has sold approximately one-third of the units (assuming all units are of equal value), but more than one year after the taxpayer has held his stock in the corporation, the corporation is liquidated and the taxpayer/shareholder claims capital gain treatment on the proceeds of the liquidation, including the fair market value of units received by him that have appreciated due to the corporation's conversion, development, and promotional activities. Assuming the maximum individual and corporate tax rates, the parties' combined effective tax rate on the profits attributable to the development and sales-related activities will be approximately 32 percent, instead of the normal 50 percent rate for such profits. Even greater overall rate reductions may be available if the corporation maximizes its use of the graduated corporate tax rates (particularly by spreading its sales of one-third of the units over two taxable years) or if the corporation has multiple, but separately indentifiable, properties. The collapsible corporation rules contained in Code section 341, which were enacted to deal with situations of this type, would not prohibit the planning technique described above. See Rev. Rul. 72-48, 1972-1 C.B. 102. We recommend that consideration be given to making discrete amendments to Code section 341 to preclude the use of this abusive technique.

H.R. 2476—RETROACTIVE EXEMPTION OF GAIN REALIZED ON NET GIFTS

H.R. 2476 would provide retroactive relief from a 1982 Supreme Court decision holding that the Federal gift tax liability assumed by the donee in a "net gift" transaction is an "amount realized" by the donor for income tax purposes. Treasury opposes this bill.

Background

The primary obligation to pay the Federal gift tax is imposed on the donor. Sometimes a donor makes a gift on the condition that the donee satisfy the donor's obligation to pay the tax. This type of transfer is known as a net gift. The Internal Revenue Service has consistently taken the position in litigation that a net gift is a taxable transaction for income tax purposes. Moreover, a 1971 gift tax ruling stated that a net gift constitutes a gift in part and a sale in part. The Service observed that, if at the time of the transfer, the gift is made subject to a condition that the donee pay the gift tax, the donor receives consideration for the transfer in the amount of the gift tax. Accordingly, the Service ruled that the value of the gift for gift tax purposes is measured by the fair market value of the property transferred, minus the amount of the gift tax to be paid by the donee. Under Treasury regulations outstanding since 1957, in the case of a transfer that is in part a sale and in part a gift (other than a transfer to a charitable organization), the transferor has a gain to the extent that the amount realized by him exceeds his basis in the property.

In *Diedrich* v. *Commissioner,* 457 U.S. 191 (1982), the Supreme Court in an 8-1 decision confirmed that the donor realizes gain when the donee agrees to discharge the donor's obligation to pay the gift tax and the gift tax liability exceeds the donor's basis in the transferred property. The Court found that this conclusion flowed from its 1929 holding in *Old Colony Trust Co.* v. *Commissioner,* 279 U.S. 716 (1929), that payment of an employee's income taxes by an employer constituted income to the employee, since the federal gift tax was as much the legal obligation of the donor as the donor's income taxes. Moreover, the Court relied on its 1947 ruling in *Crane* v. *Commissioner,* 331 U.S. 1 (1947), that when property is disposed of subject to a mortgage, the amount realized by the transferor includes the forgiveness of the debt obligation.

Description of H.R. 2476

H.R. 2476 would provide that where a gift was made before March 4, 1981, gross income of the donor shall not include any amount attributable to the donee's payment of (or agreement to pay) the gift tax imposed. The relief extended by H.R. 2476 may be claimed within one year of enactment, even though the statute of limitations on the year in question has run.

Discussion

The March 4, 1981, cutoff date under H.R. 2476 is the date of the decision of the U.S. Court of Appeals for the Eighth Circuit in *Diedrich.* The Eighth Circuit reached the same conclusion as did the Supreme Court. Presumably, the rationale for the March 4, 1981, date is that until the Eighth Circuit's decision taxpayers were not on notice that a net gift would give rise to taxable gain to the donor. As I mentioned above, however, the Service's published position had been clear at least as far back as 1971. Although several lower courts had ruled against the Service, taxpayers were on notice that the failure to report gain on a net gift would likely be opposed on audit. Moreover, in 1974, the U.S. Court of Appeals for the Sixth Circuit upheld the Service's position. *Johnson* v. *Commissioner,* 495 F.2d 1079 (6th Cir. 1974). In that case, the donor borrowed from a bank using stock as a security and then transferred the encumbered stock in a gift transaction, using the loan proceeds in part to pay the gift tax. The Sixth Circuit held that the assumption of the donor's obligation constituted income to the donor no matter what the loan proceeds were used for. Alternatively, the Court held that, even apart from the prior encumbrance of the property, "the payment of a donor's gift tax liability by the donee constitutes income to the donor." 495 F.2d at 1083.

The above history shows that the *Diedrich* decision could not have come as a surprise to the taxpayers involved. It was grounded in well-known and longstanding Supreme Court precedents, *Old Colony Trust Co.* and *Crane.* Although several lower courts had ruled in favor of taxpayers on the issue, taxpayers knew that the matter would not be finally resolved until a net gift case reached the Supreme Court, and that they were taking a calculated risk in failing to follow the IRS position. The *Johnston* decision, upholding the IRS differed from the typical net gift case in that it involved a prior encumbrance of the property; but, as the Court of Appeals noted in *Diedrich,* this additional step was irrelevant to the tax result.

The reliance argument that is presumably intended to justify H.R. 2476 accordingly lacks any substantial basis. Furthermore, the taxpayers involved have enjoyed rather favorable tax treatment on balance, making any additional relief unwarranted. This favorable treatment can be illustrated by an example. Suppose that stock worth $1,000 having a basis of $100 was transferred in a net gift transaction, resulting in a $200 gift tax. In *Diedrich* and similar cases, the donor's entire basis was allowed to be offset against the amount realized in computing taxable gain. Thus, the taxable gain in the example would be $100. The benefit from being allowed to offset the entire basis against the assumed liability can be seen by comparing the transaction to a bargain sale to charity. If property worth $1,000 were sold to a charity for $200, section 1011(b) would permit only one-fifth of the $100 basis to be used in computing taxable gain. In the example, the gain would be $200 minus one-fifth of the $100 basis ($20), or $180—$80 more than in the noncharitable net gift case.

In addition to treating the donor favorably, the rules governing net gifts are favorable to the donee. In the usual case, the donee's basis is increased by the amount he pays for the property (the amount of the gift tax), in addition to the increase in basis to reflect the gift tax payment pursuant to the usual rules of section 1015(d). Thus, while the donor realizes gain, the increase in the donee's basis correspondingly reduces the taxable gain that the donee must report when he sells the property. H.R. 2476 would not change the tax treatment of the donee. The donee accordingly would receive a basis step-up even though the donor would be relieved of liability for the gain. Such a double benefit to the donor and donee cannot be justified.

For the foregoing reasons, we oppose H.R. 2476.

H.R. 2504—TAX EXEMPTION OF OBLIGATIONS ISSUED BY LAND GRANT COLLEGES

H.R. 2504 would amend Code section 103 to provide that gross income does not include interest on obligations of a "qualified educational organization." A qualified educational organization is a college or university that was created by a specific act of a State legislature and that is a "land grant college" under the "Morrill Act" (7 U.S.C. § 30). We understand that the primary beneficiary of H.R. 2504 is intended to be Pennsylvania State University. The bill has a retroactive date designed to confer tax-exempt status on certain outstanding obligations of Pennsylvania State University that the Internal Revenue Service has determined to be taxable. Treasury opposes H.R. 2504.

Background

Under present law, the interest on certain obligations of States and their political subdivisions is exempt from Federal income tax. Code section 103 provides the authority for State and local governments (or instrumentalities acting on their behalf) to issue tax-exempt bonds, including bonds that finance public projects such as roads, sewers and prisons, as well as bonds that finance certain qualifying activities which directly benefit private persons (including "industrial development bonds", "student loan bonds" and "mortgage subsidy bonds").

Only specified types of entities are entitled to be issuers of tax-exempt bonds. States and their political subdivisions are qualified issuers of tax-exempt bonds. Longstanding Treasury regulations have extended the tax-exempt borrowing privilege to include "constituted authorities" empowered to issue obligation "on behalf of" States or their political subdivisions (known as "on behalf of" issuers). See Treas. Reg. § 1.103-1(b). In general, States, their political subdivisions, and "on behalf of" issuers are the only types of issuers of tax-exempt bonds under present law. (There is a limited exception for "qualified scholarship funding bonds," which may be issued by certain nonprofit corporations organized at the request of a State or one of its political subdivisions for the purpose of acquiring student loan notes.) Other persons, including private entities, often are able to receive the benefit of the tax-exempt borrowing privilege, but only if they can induce a qualified issuing entity to issue tax-exempt bonds for their benefit. Nevertheless, the ultimate responsibility rests on qualified issuers of tax-exempt bonds to determine if a project has a sufficient public purpose to warrant financing with tax-exempt bonds. Because of the importance of this function, the tax-exempt borrowing privilege generally has been limited to entities that are truly public and governmental in nature.

A political subdivision of a State is defined as a division of a State or local governmental unit that has been delegated a substantial part of the sovereign powers of the unit. Three sovereign powers have been recognized under the case law: the power to tax, the power to eminent domain, and police power (the power by regulation to promote public health, morals or safety). See *Commissioner* v. *Shamberg's Estate,* 144 F.2d 998 (2d Cir. 1944), cert. denied, 323 U.S. 792 (1945). A political subdivision need not be delegated all of these powers to qualify as an issuer of tax-exempt obligations; delegation of only one sovereign power is enough as long as it is a substantial delegation of authority. However, the U.S. Court of Appeals for the Third Circuit recently has held that the power of a State-supported university to receive appropriations from the State legislature out of funds derived from tax revenues does not give the university the power to tax. That court also held that the right to maintain a campus police force having limited on-campus powers does not give the university substantial police powers. See *Philadelphia National Bank* v. *United States,* 666 F.2d 834 (3rd Cir. 1981), cert. denied, 457 U.S. 1105 (1982) (holding that Temple University, another State-supported university in Pennsylvania, is not a political subdivision of that State).

An "on behalf of" issuer is an entity which is established to carry out a public purpose for a political subdivision, and which has sufficient connections with the subdivision that it can be viewed as its alter ego. For example, in the *Philadelphia National Bank* case, the court described an "on behalf of" issuer as one that is wholly governmentally controlled and that performs a wholly governmental function. The court looked to whether there was an identity of interest, control, or intent between the political subdivision and the purported "on behalf of" issuer. 666 F.2d at 842. Thus, the political subdivision and "on behalf of" requirements serve the beneficial purpose of limiting the tax-exempt borrowing privilege to entities that are fully subject to political control and are accountable for their actions at the State or local government level.

Congress recently has confirmed the importance of political control over and accountability for the exercise of the tax-exempt borrowing privilege. In the Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA), Congress enacted a "public approval" requirement applicable to all tax-exempt industrial development bonds. This requirement prohibits issuance of such bonds unless they have been approved by elected officials after a public hearing, or by a voter referendum. This public approval requirement is designed to insure that a valid public purpose is served by the bond issue.

Discussion

H.R. 2504 would move in the opposite direction from the TEFRA reform by allowing the issuance of tax-exempt bonds by land grant colleges that cannot meet either the political subdivision or the "on behalf of" tests of current law. Thus, in the case of obligations issued by Pennsylvania State University, the tax-exemption would be available even though the State does not control a majority of the governing board of the university and has not granted to the university any substantial governmental powers. We question the wisdom of granting the tax-exempt borrowing privilege to entities that are not subject to complete control by the political process. Furthermore, there is nothing in the Federal statutory provisions applicable to land grant colleges insuring that they are wholly controlled instrumentalities of the States, or that they possess any substantial governmental powers. Thus, status as a land grant college appears to be irrelevant to the question of whether a university should be an eligible issuer of tax-exempt bonds.

Denying the tax exemption for obligations issued by institutions such as Pennsylvania State University does not work any unfair hardship on them. If an expenditure by the university indeed serves a valid public purpose, the university is free to ask the State or one of its political subdivisions to issue tax-exempt bonds for that purpose. If the university desires to avoid the public scrutiny that this may entail, it is reasonable to question whether its borrowings in fact serve a public purpose sufficient to justify the tax exemption. Furthermore, if the Pennsylvania legislature views the university as a true governmental body that ought to have the tax-exempt borrowing privilege, the legislature could grant sufficient governmental powers to the university to make it a political subdivision. If the legislature declines to do this, one may again reasonably question whether the university ought to have the tax-exempt borrowing privilege. For whatever reason, the university has not obtained the additional powers from the State legislature that would qualify it as a valid issuer of tax-exempt bonds. There is no reason why Congress should confer the tax-exempt borowing privilege on Pennyslvania State University if the Pennsylvania legislature has declined to do so.

For the foregoing reasons, Treasury opposes H.R. 2504.

H.R. 2831—DISASTER LOSS TREATMENT OF LOSSES ON DEMOLITION OR RELOCATION OF RESIDENCES

H.R. 2831 would amend Code section 165 to provide that a loss in connection with a residence located in a disaster area will be treated as a deductible disaster loss under Code section 165 if the taxpayer is ordered by a State or local government to demolish or relocate the residence because of a danger of mudslides, earthslides or flooding. The order must be issued within 120 days after the area is determined by the President to warrant assistance by the Federal government under the Disaster Relief Act of 1974. H.R. 2831 would be effective retroactively to taxable years beginning after December 31, 1981. The retroactive effective date is intended to benefit certain taxpayers who have been denied casualty loss deductions under an administrative determination by the Internal Revenue Service.

In general, Treasury does not oppose the thrust of the substantive provisions H.R. 2831, although we believe that certain limitations should be added. However, Treasury opposes the retroactive effective date of the bill.

Background

Under present law, individuals are not entitled to deduct losses with respect to nonbusiness property (or property that is not held for the production of income) unless the loss arises from fire, storm, shipwreck, or other casualty, or from theft. Casualty and theft losses are deductible only to the extent that they exceed $100 per occurrence, and the aggregate of all casualty losses sustained in the year exceeds 10 percent of the taxpayer's adjusted gross income. Casualty losses incurred in a major disaster designated as such by the President for purposes of the Disaster Relief Act of 1974 may be claimed either in the year of the loss, or the taxable year preceding the year of the disaster.

Casualty losses are those which are caused by a sudden, unexpected or unusual event, or an unexpected accidental force of a type which the taxpayer is powerless to prevent because of its suddenness. Earthslides or sudden earth movements may cause a casualty. However, a prerequisite to showing a deductible casualty loss is actual physical damage or destruction of property. A mere decline in market value attributable to damage to nearby property or to the potential for future damage to the taxpayer's property is not a casualty loss. See generally *Kamanski* v. *Commissioner,* 477 F.2d 452 (9th Cir. 1973); *Citizens Bank* v. *Commissioner,* 28 T.C. 717 (1957), aff'd, 252 F.2d 425 (4th Cir. 1958). Casualty losses have been denied when undamaged property in a flood plain was condemned for a flood control project after a flood, since there was no proximate relationship between the flooding and the loss on the condemnation. Rev. Rul. 70-16, 1970-1 C.B. 36. In a similar case, a loss in market value of property following a landslide within 250 feet of the taxpayer's property was held not a casualty loss, since the loss was not caused by the slide itself, but was caused by pre-existing soil conditions that led to predictions of future casualty losses. In this case, the court noted that a casualty loss would be available only when and if actual damage was sustained in the future. See *Kamanski* v. *Commissioner,* supra. Finally, expenses for precautionary steps to prevent future casualties generally are not deductible as casualty losses. *Austin* v. *Commissioner,* 74 T.C. 1334 (1980) (disallowing deduction for expenses of tree removal to prevent a future casualty in an ice storm).

Discussion

The purpose of the rules discussed above is to deny deductions for casualty losses attributable to the decline in market value of property based on predictions of future casualties until a casualty actually occurs. As a general rule, a taxpayer who buys property in an area prone to casualties should not be allowed to deduct speculative future losses on the property as long as the property itself is undamaged by any casualty. Predicted casualty losses may not actually occur for many years, if at all. But for this rule, large numbers of homeowners residing in areas prone to mudslides, floods or earthquakes could deduct predicted future losses at a huge revenue cost to the Federal government.

Treasury believes that the present law rules in this area generally are sound. Nevertheless, we recognize that if a disaster designated by the President as a major disaster does occur, and the taxpayer's property is not physically damaged but is rendered unsafe for occupation as a direct result of the disaster, a taxpayer would lose his potential future casualty loss deduction if the property were condemned and demolished or removed before the future casualty (which, in these cases, is almost certain to occur) in fact does occur. In this narrow situation, we believe that a finding by a local governmental body that the property is unsafe for occupation and must be condemned as a direct result of the disaster generally should be sufficient to distinguish the case from a mere decline in market value of property, which should not give rise to a deduction. It would be poor public policy to create tax incentives to postpone demolition of unsafe structures until actual physical damage occurs. Moreover, it is unfair to allow a loss to a taxpayer whose residence has been physically destroyed and, at the same time, deny a deduction to a neighbor with an undamaged residence that is rendered uninhabitable by the same disaster.

In contrast, if a disaster occurs and the government condemns undamaged property that was subject to pre-existing unsafe conditions but was not in any way adversely affected by the disaster, we believe that the condemnation should not be considered a deductible disaster loss. Otherwise, losses resulting from declines in market value might become deductible because of the coincidence that some other property in the vicinity was destroyed, as long as a local government issues a condemnation order.

Thus, Treasury would support relief similar to that provided in H.R. 2831 if a provision were added predicating a deductible loss on a governmental order to remove or demolish the property based on an imminent danger to the property that is a direct result of the disaster (and not solely a result of conditions that existed before the disaster, even if these conditions were not known until after the disaster). In order to prevent collusive condemnations, the Internal Revenue Service should not be bound by the governmental order if its own examination of the facts discloses that the order was without sufficient factual basis. Furthermore, any order that is requested or initiated by a taxpayer should not be taken into account for purposes of the amendment.

Our proposed rule can be illustrated with two examples. If a house is condemned because there is an imminent danger that debris from another house destroyed in the disaster will fall and crush the condemned house, we believe that a casualty loss should be allowable. However, if mudslides occur in a portion of a county and houses are condemned in an area that was not directly affected by the slides after a post-disaster report discloses unsafe soil conditions that existed before the disaster, no deduction should be allowable. The latter situation more closely resembles a decline in market value due to poor soil quality than a destruction of the property by casualty.

Notwithstanding our general support for the concept of H.R. 2831, Treasury opposes the retroactive effective date of the bill. It is unfair to single out one group of taxpayers for retroactive relief (those involved in disasters after 1981) when other similarly situated taxpayers are not granted retroactive relief merely because they have not been identified. In addition, it is disruptive to the administration of our tax system if disputes with respect to taxpayers under existing law are resolved in the context of requests for retroactive relief from Congress.

H.R. 3096—ATTEMPTS TO CIRCUMVENT TAX STRADDLE AND ACCUMULATED EARNINGS TAX RESTRICTIONS THROUGH FOREIGN CORPORATIONS

H.R. 3096 deals with two problems with current tax law which allow taxpayers to claim unintended tax benefits. Treasury strongly support this bill.

Use of foreign corporations to avoid loss deferral rules

The tax straddle restrictions enacted in ERTA can be summarized for present purposes as two general rules:

Commodity futures contracts traded on a domestic board of trade or exchange that are held on the last day of the taxpayer's year are treated as sold (market to market) on that day; all capital gains and losses from transactions in such commodity futures are treated as 60 percent long-term and 40 percent short-term, resulting in a maximum rate of tax on gains of 32 percent. This rule is in Internal Revenue Code section 1256.

For transactions in actively traded property other than commodity futures contracts subject to the above rules, a loss deferral rule denies loss deductions on positions sold to the extent that there is unrecognized gain in an "offsetting position" at the close of the year. Separate wash sale and short sale rules also are made applicable to straddle transactions. The foregoing rules are embodied in Internal Revenue Code section 1092; for convenience, they will be referred to as the "loss deferral" rules.

A problem that has developed in the straddle area involves straddes in which one leg consists of a directly held position and the other leg consists of an interest in a foreign corporation that holds a position that offsets the directly held position. In some cases, taxpayers may be able to structure the transaction so that they may claim a loss on the directly held position while the offsetting position held through the foreign corporation will produce a gain. By closing out the loss leg prior to the close of the tax year, a loss can be established for tax purposes. (As is typical of straddle transactions, after establishing the loss, the taxpayer would promptly acquire a position similar to the position closed out to maintain a balanced position, thereby avoiding risk of market fluctuations.) The reciprocal gain in the foreign corporation will not bring the loss deferral rules of section 1092 into play because ownership of "stock" is never treated as a "position." As a result there is neither an "offsetting position" nor a "straddle."

If effective, this transaction would involve a circumvention of the tax straddle rules of ERTA, solely by means of the utilization of a foreign corporation to hold one leg of the straddle. The Internal Revenue Service could well be successful in challenging such transactions on a variety of theories. Nonetheless, we favor a statutory amendment to the straddle rules which will clearly eliminate these abusive transactions.

H.R. 3096 would remedy the problem presented by this transaction by amending section 1092 to include "offsetting position stock" in the definition of the term "position." Offsetting position stock would be defined as "stock of a corporation formed or availed of to take positions in personal property which offset positions taken by shareholders."

We agree that in circumstances such as those described above, corporate stock should be treated as a "position." We have some concern, however, that a test that looks only to the intention for forming or utilizing the corporation might not be effective in some cases in which taxpayers are willing to adopt aggressive return filing positions. Therefore, we would prefer a definition of offsetting position stock that looks to objective criteria such as the asset composition of the corporation and the extent to which the corporation has other characteristics that make it a vehicle for avoidance of the tax straddle rules.

Offshore commodity funds

Recently, interests in foreign corporations that invest in commodity futures contracts traded on U.S. exchanges have been sold to U.S. investors. As structured, these funds may produce two unintended tax benefits for investors:

The investors' profits on the futures investments are not marked to market and taxed at year end as they would be if the futures contracts were held directly or through a U.S. investment vehicle.

Profits on the futures investments are taxed at long-term capital gains rates (20 percent maximum), instead of the 32 percent maximum rate provided for gains on futures contracts.

A simplified description of the organization of a typical fund is as follows: An investment adviser will set up a foreign corporation ("X"), which in turn will set up a foreign subsidiary ("Y"). Both X and Y are incorporated in tax haven jurisdictions. X issues its shares to a large number of U.S persons. Y engages in trading in commodity futures on a U.S. exchange through an independent U.S. broker. The anticipated tax consequences of this structure are as follows:

Y is not subject to current U.S. taxation on its trading income because it is not engaged in the conduct of a U.S. trade or business.

Y is not subject to the accumulated earnings tax because it distributes dividends annually to X.

X is not subject to current tax on its income or accumulated earnings because it derives no U.S.-source income (the dividends from Y are not U.S.-source income since Y is not engaged in a U.S. trade or business).

The shareholders of X are not subject to current U.S. tax under the personal holding company, foreign personal holding company or controlled foreign corporation provisions of the Code because of the widely diversified ownership in X.

The shareholders of X can obtain long-term capital gains treatment on a sale of their X stock. X is not treated as a foreign investment company under section 1246 of the Code. Section 1246 provides that gain from the sale of the stock of a foreign corporation will result in ordinary income if more than 50 percent of the voting power or value of the foreign corporation is owned by U.S. persons and if the corporation is engaged primarily in the business of investing or trading in securities, as defined under the Investment Company Act of 1940. However, commodity futures contracts are not "securities" for this purpose.

H.R. 3096 would deal with the accumulated earnings tax and section 1246 problems presented by these funds. First, Code section 535 would be amended to provide that if a foreign corporation derives more than 10 percent of its earnings and profits from sources within the United States (or income effectively connected with the conduct of a U.S. trade or business), then any distribution out of such earnings received by another foreign corporation that is controlled by U.S. persons will be treated as U.S.-source income for purposes of the accumulated earnings tax. Thus, under the facts above, X could be subject to the accumulated earnings tax. Second, section 1246 would be ameded to treat investments in commodities in the manner currently provided for investments in securities, with the result that dispositions of the stock of X would result in ordinary income treatment.

Treasury believes that the changes made by H.R. 3096 are needed to deal with these attempts to avoid the rules applicable to regulated futures contracts. Thus, we support the provisions of H.R. 3096 dealing with offshore commodity funds.

H.R. 3173—EXTENSION OF CASH OR DEFERRED PLAN RULES TO SALARY REDUCTION ARRANGEMENTS UNDER MONEY PURCHASE PENSION PLANS

H.R. 3173 would extend to salary reduction money purchase pension plans in existence on June 27, 1974, the rules applicable to cash or deferred arrangements under qualified profit sharing or stock bonus plans. Treasury supports H.R. 3173.

Background

H.R. 3173 would amend section 401(k) of the Internal Revenue Code to permit the tax qualification of certain money purchase pension plans which were in existence on June 27, 1974, and which on that date provided for plan contributions under salary reduction arrangements. The narrow focus of the bill can be explained by the long history of these cash or deferred arrangments ("CODAs"), under which an employer gives the employee a choice between being paid a specified amount in cash as current compensation or having that amount contributed to a retirement plan. Under "cash option" CODAs, the deferred compensation is an annual bonus, while under "salary reduction" CODAs, the deferred compensation represents either a reduction in the employee's basic or regular rate of compensation or a foregone increase in such compensation.

Long before the enactment of the Employee Retirement Income Security Act of 1974 ("ERISA"), the Internal Revenue Service, in Rev. Rul. 56-497, upheld the tax qualification of a cash or deferred profit sharing plan where over one-half of the plan participants electing deferral were among the lowest paid two-thirds of all eligible employees. In later rulings, the Revenue Service imposed upon salary reduction plans the additional limitation that a participating employee could not reduce his salary by more than six percent.

In December 1972, the IRS proposed regulations that would have taxed employees currently on all income which they had an option to receive currently, even if that amount was deferred into a qualified profit sharing of money purchase plan. Later, in February 1978, additional regulations were proposed that would have taxed to the employee amounts deferred pursuant to an "individual option" salary reduction agreement under a nonqualified plan or arrangement. Although the 1972 proposed regulations applicable to qualified plans were withdrawn in 1978, the withdrawal notice indicated that the IRS had not changed its general position opposing salary reduction arrangements.

In reaction to the 1972 proposed regulations, and in order to allow time for Congress to study the entire area, ERISA in 1974 provided for a temporary freeze on the promulgation of final regulations regarding salary reduction arrangements in existence on June 27, 1974. Under the temporary freeze, employer contributions made under salary reduction arrangements to profit sharing or money purchase plans that satisfied the requirements of pre-1972 law were not includible in the income of the covered employees. This freeze, which originally applied until January 1, 1977, was twice extended by specific legislation; but it expired on January 1, 1980.

The Revenue Act of 1978 settled some of the controversy over the salary reduction issue, through the enactment of Code section 401(k), establishing special qualification rules for old and new profit sharing and stock bonus plans containing salary reduction features. Of particular note are the special eligibility and nondiscrimination rules provided for these plans as an alternative to the normal nondiscrimination tests applicable to qualified plans. Under these special rules, the actual average deferral percentage for the highest paid one-third of all participants must not be more than 1.5 times (or, in certain circumstances, 2.5 times) the average deferral percentage for the other plan participants. These new rules were not applied, however, to salary reduction arrangements under money purchase pension plans. The proposed regulations under section 401(k), which were issued in November 1981, follow the statute and therefore do not protect salary reduction arrangements under money purchase plans regardless of whether these plans were in existence on June 27, 1974.

The Revenue Act of 1978 also dealt with nonqualified salary reduction arrangements, first by granting a tax qualification to deferrals under eligible State and local government deferred compensation plans, and second by barring the IRS from issuing regulations or rulings covering nonqualified salary reduction arrangements of taxable employers in certain cases. No rules were porovided by the 1978 Act for nonqualified salary reduction arrangments of tax-exempt employers.

There are three remaining issues raised by the various sets of proposed regulations on salary reduction arrangements which have not yet been resolved by Congress. First, deferrals under salary reduction money purchase plans in existence on June 27, 1974, will be taxed if the 1981 proposed regulations implementing the CODA rules enacted by the 1978 Revenue Act are made final, because the ERISA freeze protecting these plans expired on January 1, 1980. Second, deferrals under any salary reduction money purchase plan established after June 27, 1974 will be taxed if the 1981 proposed regulations are made final. (These plans were never protected by the ERISA freeze.) Finally, deferrals at an individual's option by employees of tax-exempt organizations will be taxed if the 1978 proposed regulations dealing with nonqualified salary reduction arrangements are made final because the freeze enacted by the 1978 Revenue Act protected only salary reduction arrangements of taxable organizations.

Description of H.R. 3173

H.R. 3173 solves the first of these three outstanding salary reduction issues by permitting any money purchase plan including a salary reduction arrangement in existence on June 27, 1974, to continue the salary reduction arrangement after December 31, 1979. However, these plans would not be permitted to increase the level of either employer or employee contributions above the level provided by the contribution formula in effect on June 27, 1974. In addition, for plan years beginning after December 31, 1980, these pre-1975 salary reduction money purchase pension plans would be subject to the special eligibility and nondiscrimination standards applied by the 1978 Revenue Act to cash or deferred profit sharing and stock bonus plans.

Treasury supports H.R. 3173 in recognition of the fact that the disqualification of salary reduction arrangements under the plans which were in existence on June 27, 1974, would no doubt reduce both employee participation and the level of retirement contributions by those employees who continue to participate in the plans. These plans have been operating for over nine years udner the expectation that Congress would enact some rules permitting their continued operation. Now that the statutory freeze protecting these plans has expired, two alternatives will remain if existing law is applied to them: (1) the plans will have to be amended to replace the shared employer-employee funding with what would probably be a reduced level of employer-only funding; or (2) the employees will be taxed on their share of contributions, which will require a greater cash outlay by each employee to maintain the same level of retirement savings. Either result is undesirable. Accordingly, Treasury supports this proposal to permit the continuation of pre-1975 salary reduction arrangements under money purchase pension plans.

In addition, Treasury would recommend that Congress make a further attempt to solve the two remaining salary reduction issues outlined above, relating to money purchase plans established after June 27, 1974, and to nonqualified deferred compensation arrangements of tax-exempt organizations. We support the concept of extending the section 401(k) rules to all money purchase plans, including plans established after June 27, 1974. In contrast to CODA contributions under a profit sharing plan, contributions under a money purchase plan can be made even if the employer has no current or accumulated profits. Thus, state and local governments, tax-exempt organizations, or companies without strong profit positions, which could not promise annual contributions to a profit sharing plan, could promote regular retirement savings through salary reduction arrangements under a money purchase pension plan. The imposition of the special participation and nondiscrimination standards upon these plans will assure the provision of retirement income benefits for rank-and-file employees.

With respect to nonqualified salary reduction arrangements of tax-exempt employers, Treasury would recommend that these arrangements be made subject not only to special participation and nondiscrimination standards, but also to some maximum deferral limits. Here again, the special qualification rules will encourage broad-based, nondiscriminatory participation in the plans, while the imposition of ceilings on the deferrable amounts will prevent the accumulation of tax-favored savings beyond the level necessary to provide adequate retirement income. Nevertheless, pending the development of legislation to address these other salary reduction issues, Treasury supports the enactment of H.R. 3173.

H.R. 3592—MISCELLANEOUS TAX CHANGES

H.R. 3592 would made a number of changes in various provisions of the Internal Revenue Code. Section 2 of the bill would allow tax-free rollovers to individual retirement accounts for certain partial distributions from qualified plans. Sections 3 and 4 of the bill would amend the expense and loss disallowance rules applicable to transactions between related parties under section 267 of the Code. Section 5 of the bill would extend to preferred stock investments the special ordinary loss treatment currently provided by Code section 1244 for qualifying common stock investments. Section 6 of the bill would make a technical clarification to section 103 of the Code. I will discuss the various sections of the bill separately.

Section 2: IRA rollover of certain partial distributions

Section 2 of H.R. 3592 would amend the Internal Revenue Code to permit certain partial distributions from pension, profit sharing, stock bonus, and annuity to be rolled over to individual retirement accounts (IRAs) without the payment of current tax.

Treasury supports H.R. 3592. The proposed changes would promote savings for retirement and simplify one of the more complex areas of the tax law. Tax-free rollovers of large partial distributions also would enable recipients to avoid the relatively harsh tax consequences applicable to partial, as opposed to lump-sum, distributions.

Background

Under current law, a lump-sum distribution from a qualified plan is eligible for various forms of special tax treatment. First, part of the distribution may qualify for capital gains treatment. Second, if employer securities attributable to employer contributions are included in the distribution, any unrealized appreciation in their value since their acquisition by the plan is not subject to tax until the securities are subsequently sold. Third, all or part of the distribution may qualify for special 10-year forward averaging treatment, under which the distribution is taxed as though it were received ratably over a 10-year period and was the only income earned in each such year.

The availability of these forms of special tax treatment is based, in part, on the premise that the recipient will have little or no additional income during his retirement years. Thus, the availability of the forms of special treatment has been limited to lump-sum distributions. A lump-sum distribution generally is a distribution of the total balance to the credit of the employee in all similar plans maintained by the employer.

The tax-free rollover privilege also is available only for lump-sum distributions. Under the rollover rules, the recipient of a lump-sum distribution from a qualified plan may avoid current tax on the distribution by rolling over the distribution to an IRA or to another qualfied plan. Tax is then paid only as the amounts are distributed from the IRA or other plan.

None of the forms of special tax treatment discussed above is applicable to a distribution from an IRA, even if the distribution would constitute a lump-sum distribution if it were from a qualified plan. As a result, rollovers of lump-sum distributions to IRAs enable a recipient to avoid current tax only if the recipient forgoes other forms of special tax treatment.

Distributions from qualified plans that do not constitute lump-sum distributions are taxed very differently under current law. Partial distributions, including annuity or other periodic payments, are includible in income in the year in which received to the extent attributable to previously untaxed amounts. They are not eligible for special tax treatment and may not be rolled over to an IRA or other qualified plan. A distribution subsequent to a partial distribution, however, may qualify as a lump-sum distribution and thus may be eligible for special tax treatment or may be rolled over to an IRA without immediate tax.

Congress has liberalized the rollover rules on several occasions in recent years. In 1974, when special treatment for rollovers was introduced, only complete rollovers of lump-sum distributions from qualified plans were permitted. Since 1974, the rollover rules have been liberalized to permit partial rollovers of lump-sum distributions, rollovers of lump-sum distributions from section 403(b) annuities, rollovers of lump-sum distributions received by a spouse upon the death of a participant, rollovers of total distributions that did not meet certain of the technical lump-sum distribution rules, and rollovers of total distributions received due to plan termination or a sale of a subsidiary's stock or assets. These changes reflect a consistent policy of encouraging individuals to maintain their savings for retirement needs.

In 1980, Congress first extended tax-free rollover treatment to one type of partial distribution. An employee who received a total distribution from a money purchase pension plan was allowed to roll over the distribution even though the employee continued to have an amount to his credit in a defined enefit pension plan. Before 1980, the rollover rules required that money purchase pension plans and defined benefit pension plans be treated as one plan for purposes of determining whether the employee had received the balance to his credit. This rule was changed because few defined benefit plans permit total distributions and, thus, few taxpayers who participated in both money purchase and defined benefit pension plans were able to take advantage of rollover treatment for distributions from their money purchase plans.

In the Economic Recovery Tax Act of 1981, Congress further extended the rollover rules to another type of partial distribution. ERTA enacted rules authorizing employees to make deductible employee contributions to either IRAs or qualified plans that elect to accept such contributions. Because amounts attributable to such contributions were to be accounted for separately from other amounts by a qualified plan and were not to be eligible for any of the forms of special tax treatment, ERTA also enacted relatively liberal rollover rules with respect to such amounts. In particular, ERTA provided that an employee who receives a partial distribution of his accumulated deductible employee contributions from a qualified plan or section 403(b) annuity may roll over that distribution to an IRA or another plan or annuity that accepts deductible employee contributions.

Description of section 2

Section 2 of H.R. 3592 would liberalize the rules further to permit rollovers of certain partial distributions. Specifically, the bill would permit the recipient of a partial distribution from a qualified pension, profit sharing, stock bonus or annuity plan or a section 403(b) annuity to roll over all or a portion of the distribution to an IRA if the distribution is at least 50 percent of the balance to the credit of the employee and is not one of a series of periodic payments. In determining the balance to an employee's credit, it would be necessary to aggregate the employee's interests in all similar plans maintained by the employer, except that, as under current law, it would not be necessary to aggregate a money purchase pension plan with a defined benefit pension plan. The bill also would deny capital gains and 10-year averaging treatment to any lump-sum distribution to the employee after the partial distribution.

Discussion

The Treasury Department supports section 2 of H.R. 3592. Rollovers originally were made available in order to facilitate the portability of qualified retirement savings, particularly as employees changed jobs. Expanding the rollover rules to include partial distributions would further serve this original purpose and thus would promote the important policy of encouraging employees to save for retirement. In addition, permitting rollovers of partial distributions would enable recipients to avoid the relatively harsh tax consequences that may apply to large partial distributions.

Even though rollovers originally were available only with respect to lump-sum distributions, there is no basis for continuing to limit rollovers in this fashion. It has become evident that the policies favoring rollovers apply to a class of distributions that is broader than lump-sum distributions. In particular, whether a large distribution happens to satisfy the technical lump-sum distribution definition often is wholly unrelated to whether permitting a rollover of the distribution would promote retirement savings.

Finally, we agree that it is necessary to preclude individuals from rolling over payments under a life annuity or term certain contract. Generally, employees do not receive such payments until they have retired. Thus, permitting the rollover of such payments would not be consistent with the policy of permitting rollovers to encourage employees to save amounts for retirement, but instead would merely enable individuals who are receiving amounts during retirement to defer further the inclusion of such amounts in income. Thus, it is appropriate to deny rollover treatment to partial distributions that are one of a series of periodic payments.

We have one reservation with H.R. 3592 that requires mention. We are not convinced that the 50 percent requirement contained in the bill is necessary to prevent recipients from rolling over amounts that should be included in income. The restriction against the rollover of annuity and other periodic distributions should be sufficient to prevent serious abuse in this area. In addition, because H.R. 3592 would deny 10-year averaging treatment to a lump sum distribution made after any partial distribution that is rolled over, few taxpayers would be well advised to roll over a relatively small distribution that is not part of a series of periodic payments. At the least, we would support liberalizing the requirement by adopting 25 or 33 percent as the appropriate minimum distribution.

Sections 3 and 4: Tax accounting treatment of certain transactions between related parties

Sections 3 and 4 of H.R. 3592 would amend section 267 of the Code, which deals with the tax accounting treatment of certain transactions between related parties. Treasury strongly supports these sections of the bill.

Background

Under section 267(a)(2) of the Code, a taxpayer is not allowed a deduction for business expenses, investment expenses, or interest payable to certain related persons under certain circumstances. Deductions are disallowed if: (1) the otherwise deductible item is neither paid nor includible, under the payee's method of tax accounting, in the payee's gross income within the period consisting of the payor's taxable year and the following 2½ months; (2) under the payee's method of tax accounting, the amount, unless paid, is not includible in the payee's gross income for the taxable year in which or with which the payor's taxable year ends; and (3) at the close of the payor's taxable year or at any time within the following 2½ months, the payor and the payee are related in a manner specified in section 267(b). Thus, for example, a calendar year accrual basis corporation generally may not deduct in 1982 an accrued salary bonus payable to its controlling shareholder-employee, unless it paid the bonus on or before March 15, 1983. In the case of expenses paid or incurred by an S corporation to certain related persons (within the meaning of section 267(b), as modified by section 267(f)(2) to include certain other shareholders, such as those who own at least 2 percent of the stock of the S corporation), Code section 267(f) allows the S corporation to deduct such amounts (regardless of its method of accounting) only when the amounts are includible in the payee's gross income, as determined under the payee's method of accounting, regardless of whether the amounts were actually paid before or after the expiration of the 2½ month period. These provisions of section 267 were enacted to prevent related taxpayers from taking unfair advantage of the difference in operation between different methods of accounting in reporting income and deductions.[1]

In addition to these expense disallowance rules, section 267(a)(1) provides a loss disallowance rule that disallows a deduction for any loss realized on a sale or exchange of property (other than through a distribution in corporate liquidation) directly or indirectly between certain related parties (within the meaning of section 267(b)). The loss disallowance rule was enacted mainly to prevent the creation of artificial tax losses through sales between related parties.

Description of sections 3 and 4

Section 3 of H.R. 3592 would repeal the provision of present Code section 267(a)(2) that entirely disallows a deduction for otherwise deductible expenses payable to certain related persons where such amounts are paid more than 2½ months after the close of the taxpayer's taxable year. Instead, the bill would allow the taxpayer a deduction for such amounts when they are includible in the payee's gross income.

Section 4 of the bill would amend the definition of related parties for certain purposes. It would extend the expense disallowance rule (as amended by section 3 of the bill) to partnerships and partners. However, the expense disallowance rule would not apply to guaranteed payments (within the meaning of Code section 707(c) made to a partner. (Code section 706(a) provides a slightly different matching rule for guaranteed payments. Under section 706(a), the payment is includible in the taxable income of the partner in the taxable year of the partner that ends with or within the taxable year of the partnership in which the item is properly deducted or capitalized by the partnership.) In addition, section 4 of the bill would extend both the expense disallowance rule and the loss disallowance rule to transactions between corporations which are members of a controlled group of corporations (as defined in proposed Code section 267(f)(2), which uses a more than 50 percent control test). The expanded definition of related parties would apply only for purposes of the expense disallowance and loss disallowance rules in section 267 and would not apply for purposes of other sections of the Code that use the definition of related parties contained in section 267(b).

The amendments made by section 3 of the bill would apply to amounts allowable as deductions (without regard to section 267) for taxable years beginning after December 31, 1983. The amendments made by section 4 of the bill would apply to taxable years beginning after December 31, 1983.

Discussion

Treasury strongly supports sections 3 and 4 of H.R. 3592. As discussed above, the expense disallowance rule of section 267 was enacted to prevent related taxpayers from taking unfair advantage of the difference in operation between different methods of accounting in reporting income and deductions. Currently, however, section 267(a)(2) permits successive one-year deferrals of the tax attributable to expenses incurred in each taxable year. For example, the annual accrual of a salary bonus owed to a controlling shareholder/employee could result in successive one-year deferrals of the tax attributable to the bonus for each year. The successive one-year deferrals could be achieved because the corporation normally could deduct the annual accrual of the bonus in one calendar year, but the shareholder-employee normally would not recognize the income until the succeeding taxable year, assuming the bonus was paid within the first 2½ months of the succeeding taxable year.

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[1] In certain cases, Code section 404 may require matching of the deduction with the recognition of income if compensation is accrued under a plan or method deferring the receipt of such compensation and the accrued compensation is not paid within a reasonable time after the close of the payor's taxable year.

In addition, under current section 267, if the taxpayer does not pay the expenses within the 2½ month period, the sanction under current law is quite severe—a permanent denial of the deduction to the taxpayer. Section 3 of H.R. 3592 would ease the sanction and, at the same time, eliminate the successive one-year deferral opportunity.

The effect of the changes made by section 3 would be to require a matching of the payor's deduction with the recognition of income by the related payee. We also recommend that the bill make clear that the expense disallowance rule would apply not only to expenses deductible under Code sections 162, 212, and 163, but also to expenses deductible under other sections of the Code, such as Code section 174 and other relevant sections of part VI of subchapter B, and Code sections 248, 616, and 709.[2] We believe strongly that the changes made by section 3 of H.R. 3592 are appropriate steps towards correcting current deficiencies in the Code.

We also support the amendments made by section 4 of H.R. 3592 to extend the expense disallowance rule to partnerships and members of a controlled group of corporations and to extend the loss disallowance rule to members of a controlled group of corporations. We suggest, however, that the bill should be amended to expand the related parties to which both the expense and loss disallowance rules in section 267 apply, to include certain other relationships, such as a partnership and a C corporation if the same persons own more than 50 percent of each entity. We also suggest that consideration be given to allowing the expanded definition of related parties in section 267 (as well as the definition of related parties under section 707(b)(1) dealing with certain sales between partnerships and their partners) to apply throughout the Code, wherever the definition in section 267(b) is incorporated by reference.

Section 5: Ordinary loss treatment for preferred stock

Section 5 of H.R. 3592 would amend Code section 1244 to treat losses on preferred stock of certain small business corporations as ordinary losses. Treasury opposes this change.

Under present law, losses from the sale, exchange or worthlessness of stock which is a capital asset generally are capital losses. Capital losses of individuals may be deducted in full against capital gains, but only to a limited extent against ordinary income. Section 1244 provides an exception to the general rule, and allows individuals to deduct losses on sale, exchange or worthlessness of "section 1244 stock" as ordinary losses. Section 1244 stock is common stock of a qualifying small business corporation that meets several statutory requirements.

Section 1244 was enacted to encourage investments in small businesses by reducing the risk of loss to the investors. In addition, it was intended to place investors in corporations on a parity with investors in proprietorships and partnerships, who often may deduct losses sustained by such businesses as ordinary losses. The legislative history of section 1244 specifically states that preferred stock was not to be given the special ordinary loss treatment. We believe that this rule is sound and should not be changed.

As previously stated, section 1244 reduces the risk of loss to those who place their capital at risk in a common stock investment in a small business. An investor who buys preferred stock, because of the preference of the stock with respect to dividends and rights in liquidation, may have much greater protection against loss compared to the common stockholders. Furthermore, preferred stock often represents a fixed charge against the earnings of a corporation, and in many ways resembles debt more than equity. This is especially true if the issuing corporation is obligated to redeem the preferred stock after a specified period, which is a common requirement imposed on issuers of preferred stock. Since preferred stock does not necessarily represent a permanent investment in the corporation, the risk of loss with respect to preferred stock is further reduced. Investors in preferred stock therefore do not need the same ordinary loss incentive to make their investments as do investors in common stock. For this reason, Treasury opposes section 5.

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[2] The predecessor to Code section 267 has been applied by one court to the payment to a related party of intangible drilling costs, even though such costs may be deducted rather than capitalized by reason of a section of the Code not specified in Code section 267 (*Island Gas, Inc.* v. *Commissioner,* 30 T.C. 787 (1958), acq., 1958-2 C.B. 6). It is not clear, however, whether expenses that may be deducted by reason of sections of the Code other than sections 162, 212, or 163 would be subject to the expense disallowance rule in section 267.

Section 6: Technical clarification to section 103

Section 6 of the bill would clarify that certain amendments to Code section 103 made in the Highway Revenue Act of 1982 and in Public Law 97-473 are deemed to have been enacted in the order that they were passed by Congress (rather than the order in which they were signed by the President). Section 6 makes clear that Code section 103(m) (dealing with tax-exempt obligations exempt under provisions other than the Internal Revenue Code), which was enacted in the Highway Revenue Act of 1982, was not inadvertently repealed when the President later signed Public Law 97-473, which also contained a provision designated as Code section 103(m). Treasury supports this clarification.

H.R. 3593—DEDUCTION FOR AWAY-FROM-HOME LODGING EXPENSES IN CONNECTION WITH OUT-PATIENT MEDICAL EXPENSES

H.R. 3593 would amend the medical expense deduction provision in section 2,3 of the Code to allow the deduction of certain amounts paid for lodging while away from home primarily for medical care. While Treasury is sympathetic with the objectives of H.R. 3593, we cannot support the bill in its present form because we believe that it would create significant possibilities for abuse, and because it would not be administerable by the Internal Revenue Service. Treasury would be happy to work with this Subcommittee in attempting to fashion an amendment that is better targeted to those who deserve relief with respect to "away from home" travel for medical purposes.

Background

Under current law, personal, living and family expenses (such as non-business lodging expenses) generally are not deductible. However, itemized deductions are allowed for medical expenses in excess of 5 percent of a taxpayer's adjusted gross income. In addition to the cost of medical services, deductible medical expenses include expenses of transportation primarily for and essential to medical care. Transportation costs are not deductible if a doctor prescribes medical care and the taxpayers chooses for purely personal reasons to travel to another locality (such as a resort) to receive the treatment.

The amount allowable as a transportation deduction generally does not include the costs of meals and lodging while away from home receiving medical treatment, except where paid as a part of a hospital (or other medical institution) bill for "in-patient" care. Under the applicable Treasury regulations, mean and lodging expenses incurred to connection with "out-patient" medical treatment received while away from home are not deductible. Treas. Reg. § 1.213-1(e)(1)(iv). The purpose of this rule, which was based on explicit legislative history, was to curtail a common abuse where a patient would travel to a resort area on doctor's orders and deduct all the costs of food and lodging while on such a "medical" vacation. In *Commissioner* v. *Bilder,* 369 U.S. 499 (1962), the Supreme Court upheld the validity of the principle contained in the regulations that lodging expenses incurred as a part of medical treatement while away from home generally are not deductible.

Description of H.R. 3593

H.R. 3593 would change these rules and allow a deduction for certain out-patient lodging costs incurred while away from home for medical care. The bill seeks to limit possible abuses by restricting the deduction to expenses connected with medical care in a hospital or in a nationally or regionally recognized medical facility, but only if there is no significant element of personal pleasure, recreation, or vacation in the travel away from home. The bill is intended to assist persons who must travel to a distant city to receive treatments (e.g., a cancer patient who must travel to a nationally known cancer clinic to receive chemotherapy).

Discussion

Treasury agrees that most individuals suffering from severe medical conditions are unlikely to travel to obtain the benefits of a tax deductible vacation, and that such individuals generally should be allowed to deduct their out-patient lodging costs. Furthermore, in many cases, out-patient treatment is less costly and more efficient than in-patient treatment and should not be discouraged. However, the benefits of H.R. 3593 are not limited to a relatively narrow class of taxpayers, and the provision would be difficult to administer even for taxpayers arguably within the narrow class of intended beneficiaries.

The bill imposes no requirement that the taxpayer must be suffering from a life-threatening condition or severe physical or mental incapacity, the typical situations in which travel to a specialized facility often is necessary. Under the bill, patients might be permitted deductions for lodging costs associated with trips to distant cities to undergo discretionary minor surgery, to receive psychiatric care for a minor disorder, or to receive other medical care when there is no genuine necessity to undertake the travel. In the case of discretionary minor surgery (such as cosmetic surgery), a taxpayer could deduct his hotel costs during the treatment and recovery period as long as the treatment was rendered in a nationally or regionally recognized facility (which perhaps might be the office of a single well-known cosmetic surgeon) and the taxpayer minimized the entertainment or vacation aspects of the trip. We question whether lodging costs, which generally are non-deductible personal expenses, should be deductible in such circumstances.

With respect to the prohibition against a "significant" element of personal pleasure, entertainment or vacation, the bill presumably would allow some pleasurable, recreational or vacation aspects in connection with a trip as long as they were incidental (but not "significant"). This would be a difficult test to apply in an evenhanded manner, and would necessitate examination of the taxpayer's subjective state of mind, as well as his detailed itinerary and the gravity of his physical condition. For example, if a seriously ill (but not bedridden) patient who travels to receive out-patient treatment visits a nearby well-known amusement park, attends the theatre, or spends time with friends residing in the area during his spare time, what objective standards could be applied to determine if such activities constituted a "significant" element of personal pleasure, entertainment or recreation? [3] Given the subjectivity of the standard, many taxpayers might believe that they have a sufficient "reasonable basis" to file a return claiming the lodging deduction for disguised vacations. Providing opportunities to take aggressive positions in such situations would damage our self-assessment tax system by diminishing public confidence in the fairness of the tax laws.

Finally, we question whether the Internal Revenue Service will be in a position to administer the requirement that a medical care facility must be nationally or regionally recognized. The Internal Revenue Service is not a medical accreditation agency, and it lacks the expertise to judge the reputations of particular clinics or doctors' offices. Yet this requirement (or something like it) is essential if deductions for disguised vacations or other personal trips are to be disallowed.

If H.R. 3593 is enacted, it should include additional safeguards to restrict its benefits to persons suffering true hardship with respect to medically required travel away from home. Some possible safeguards might include:

Requiring taxpayers to meet the 5 percent adjusted gross income floor on medical expenses without regard to any expenses deductible under H.R. 3593. This would tend to assure that only those taxpayers who are sufficiently ill to have incurred substantial medical costs (other than lodging costs) will be allowed the lodging expense deduction.

Imposing a per-diem limit on the lodging costs that can be deducted. The Federal government per-diem allowance for Federal employees in travel status might be used as a guideline. A per-diem limit would reduce the incentive to incur travel and lodging costs for non-medical purposes.

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[3] Courts have had to deal with similar issues in the medical expense area in the past. In *Winderman* v. *Commissioner*, 32 T.C. 1197 (1959), the taxpayer, an IRS employee who resided in the Los Angeles area, was allowed to deduct as a medical expense the cost of round trips between Los Angeles and New York City to consult an internist in whom he had confidence for annual physical checkups. The taxpayer had hypertension, a prostatic condition, a possible hernia, and other physical conditions that were matters of concern to him. Although the taxpayer's trips to New York coincided with his wife's business trips to New York, although he spent a considerable portion of his spare time while in New York visiting former IRS colleagues, and although he occasionally attended the theatre while in New York, the Tax Court determined that the taxpayer's primary purpose in making the trips to New York was to consult with his physician. It further found as a fact that his social and recreational activities were "minor" and "distinctly secondary" to his medical visits. If the amendments proposed by H.R. 3593 had applied, and if the court's finding that the taxpayer's recreational activities were "minor" and "distinctly secondary" were taken to mean that such activities were not "significant," the taxpayer in *Winderman* also would have been allowed deductions for his lodging costs in New York City, provided that his doctor worked at a regionally recognized medical care facility.

Prohibiting the deduction for lodging costs in connection with certain specified broad classes of medical treatment not likely to necessitate travel to specialized clinics.

Requiring taxpayers who are claiming the lodging expense deduction to keep contemporaneous records of their activities while away from home to establish that their trip did not involve a significant recreational or vacation purpose.

Some or all of these safeguards (or other similar limitations) might reduce to an acceptable level the abuse potential inherent in the provision, and would not adversely affect the legitimate beneficiaries of the bill.

This concludes my prepared remarks. I would be happy to respond to your questions.

Chairman STARK. Thank you very much.

Mr. GUARINI [presiding]. Mr. Duncan.

Mr. DUNCAN. I don't have any questions at this point.

Mr. GUARINI. Mr. Vander Jagt.

Mr. VANDER JAGT. No questions.

Mr. GUARINI. H.R. 3592 that you refer to, that deals with the deferring expenses which would be put on an accrual basis as against a cash basis; is that correct?

Mr. WOODWARD. Yes, sir. The amendments made in sections 3 and 4 of the bill would amend section 267 of the code which currently provides for the total disallowance of expenses in certain circumstances and disallows losses in sales between related parties. The bill would remove a very harsh impact of the operation of the current section 267 by allowing the deduction at the time there is income inclusion by the related party.

It also would fill in some holes in the list of related parties and would generally tie the deduction by the paying party in the case of an expense payment to the time of income inclusion by the related party recipient of the payment.

Mr. GUARINI. Many of these business arrangements for development are made through HUD. Have you consulted with HUD as to their position in the matter and whether they feel that it would be a deterrent to developing many of the pieces of property that HUD is concerned with?

Mr. WOODWARD. No, Mr. Guarini, we have not done that and have not heard from them. I understand that there have been some concerns expressed about some existing arrangements. I don't think that this was in the minds of the draftsmen of the bill. Perhaps they were not aware of these arrangements being in existence. There may be a need for some consideration of transition rules, for example, because of existing deals that have been put together, structured on the basis that there would be deductions available to partnerships. We certainly would agree that this is something that should be examined by the subcommittee and we would anticipate discussing any problems in this area with appropriate officials at HUD.

Mr. GUARINI. Philosophically, you know, you may have a very strong point, but has there been any valuation made by Treasury as to whether or not many deals would be killed in redevelopment as a result of this rule change?

Mr. WOODWARD. We don't have, Mr. Guarini, certainly not at this time, any information on which to make that evaluation. I believe that you may be provided with some information in that regard later in this hearing. We certainly would consider the bill's impact, although I am not sure that is a judgment we are really able to make. We think this is an appropriate change from the standpoint of tax policy and are not aware of any overriding considerations.

I think we can distinguish the transition situations, transactions that have been structured in reliance on the terms of the Internal Revenue Code as it now stands. We think they should not be unfairly upset, we are sympathetic to that.

Now on an ongoing basis for the future, I think we need to stand back and examine the distortions that can be created, which may even be exemplified by some of the transactions for which transition relief might be granted but only——

Mr. GUARINI. Aside from being a purist, if you felt that HUD would feel that there are many situations that would never come into fruition, there would be many developments that would never take place in the housing industry. The construction industry would be hurt because there would be so many fewer starts, from a business viewpoint, would Treasury then take a different attitude?

Mr. WOODWARD. Institutionally we would adhere to the tax policy views I have expressed but certainly the administration, in coordinating the administration's position on legislation such as this, would weigh those kinds of factors, and clearly the Treasury would adhere to the administration's determinations as to whether the tax policy or the housing policy would prevail in a situation such as that.

Mr. GUARINI. I suggest that before you go much further that we do check with HUD and get what their official position and experience is so that we would know that the various agencies of the Government are in accord with each other, because it would be a terrible slippage if we lost many projects as a result of wanting to do what we thought idealistically was the right thing, but in the real world didn't work out that way.

What about the transition rule? Do you think that is fair if deals have been struck in the past, and contracts have been signed, to disallow what people depended on when they planned their development projects and syndications.

Mr. WOODWARD. It's not clear exactly where the line should be drawn in a transition rule. I don't know whether there is any hard and fast principle that can be stated except that equitable considerations should be taken into account when changing the law on a prospective basis to avoid unfairly treating those who may have expended substantial amounts in planning transactions or have committed themselves to a transaction.

Exactly where the line should be drawn I am not prepared to say now, but we certainly think that there may be some need for transition rules.

Mr. GUARINI. Where there are already contractual arrangements that the parties had made, offers and acceptance of those offers in reliance upon the existing law, would you feel that it would be a responsible position for Treasury to recognize the contracts that have been already put into effect?

Mr. WOODWARD. Mr. Guarini, we always try to look to objective facts in these sorts of situations. The existence of a binding contract, tying the parties to a deal, would be one such objective fact that has been used in the past. It might well serve as a line of distinction in this case as well.

Mr. GUARINI. So you feel there could be many ameliorating circumstances depending upon how far they have gone in regard to the contractual agreements in dependence upon existing law?

Mr. WOODWARD. Yes, sir, I think that there could be a weighing test. I don't think we are taking—I hope you understand we are not taking—a hard line here that the rug should be pulled out from under people. We think it is a good change but understand that there is some adjustment period that might be required.

I might note that the change would not become effective until the end of this year, and that different effective dates might be used for different provisions of the bill. For example, the loss disallowance rules might not have the same effective date as the expense disallowance rules.

We would need to devote some attention and really hear what sort of arrangement, get some more information about the arrangements that are affected by this change.

Mr. GUARINI. Would you be good enough to check with the other agency which would be principally concerned with this bill, which would be HUD, and inform this committee as to what their position would be regarding the bill.

Mr. WOODWARD. We would be happy to do so.

Mr. GUARINI. I appreciate that.

Just lastly, on H.R. 3593, where we talk about medical care deductions for lodging away from home, do you have any suggestion as to how adequate safeguards could be put into the law so it would not be abused?

Is there anything in the code now that is a parallel that we could pull from in order to add the necessary safeguards?

Mr. WOODWARD. There are some safeguards that we do suggest in our testimony. I believe it is about the next to last page of the written statement. There have been guidelines in other areas of the code.

For example, the per diem limit on lodging expenses is used in the provision of the code allowing deductions for away-from-home lodging expenses of State legislators. The deduction there is tied to the Federal per diem amount for a particular area, and that might be an appropriate limitation on lodging expenses here.

Mr. GUARINI. It is easy to figure out as to legitimacy, what someone in the legislature would be. It is easy to say that was his duty. In regard to all the lame excuses that could be given, where vacation could be taken, given the excuse of medical care attention, I wonder whether or not there is any way to really monitor that.

Mr. WOODWARD. Well, one aspect of the bill would require that the institution in which treatment is received be a regionally or nationally recognized institution. We think that IRS would have some real problems in dealing with that. We think, however, and agree that some limitation of that type, if we can find an acceptable one, would be desirable. We think that there could also be some limitation possible on the nature of the medical condition for which treatment is received. For example, certainly the life-threatening type of medical condition is the one that cries out for this kind of——

Mr. Guarini. It is the marginal ones we worry about.

Mr. Woodward. Yes, sir. Discretionary cosmetic surgery that might be scheduled at a vacation site, things of that nature.

Mr. Guarini. Lastly, let me switch our gears to H. 699 and ask you, is there any way a formula could be developed that could apportion the capital gains, ordinary income portions?

Is there a suggestion that Treasury might have as to how we can differentiate?

Mr. Woodward. A formula certainly could be developed and we have had discussions with some of the parties who are interested in this legislation to explore that possibility. The problem we see is this. There are a couple of types of ways to get capital gains treatment on condo conversions under current law. Selling to an independent converter is one way. A second way is to sell to a converter that you create yourself, a corporation you establish or a partnership, a related entity.

A formula approach under this bill certainly would cut down on the valuation problems, you would presumably have some sort of sliding scale, I suppose, that would treat some minimum portion of the ultimate income as ordinary income. It would be an election, since I am sure that no one would be interested in giving up the ability to sell to a converter, whether it be a related party or an independent converter, and those who are interested in this legislation clearly have indicated that that would be their view.

Therefore, the formula would provide a third item on the smorgasbord, so to speak, of tax planning alternatives and would certainly not bring about the neutrality on which the bill is premised. It would simply be another set of arbitrary rules. We therefore do not think a formula would be desirable.

If the legislation is to go forward over our objection, the subcommittee may wish to consider a formula that treats some minimum portion of ultimate profit as ordinary income. The approach is used in section 1237 of the code, which deals with a limited category of developments of raw land for subdivision purposes, which is an analogous provision. I believe section 1237 has a 5 percent minimum ordinary income component which would constitute precedent for some sort of a formula in this case.

Mr. Guarini. Would appraisal be the only way to go or are there other more sophisticated or easier ways to figure out——

Mr. Woodward. Appraisal would be the alternative to some sort of a rigid formula. The rigid formula would simply say, as I understand what is being discussed, would simply say that a specified percentage of the final sales proceeds is going to be treated as ordinary income. It would be too generous to some, too harsh on other types of deals.

If the results of the formula are too harsh, the taxpayer would presumably avail himself of one of the alternatives that are available under current law. Where the formula provides a more favorable result, he would clearly elect to use the formula approach.

We don't think that a formula is a satisfactory approach. It really abandons the theoretical argument for the bill in the first place. However, any other approach to the theoretical problem—that you ought to be able to distinguish between investment profit and selling profits, business selling profits—brings you to the appraisal quagmire.

Mr. **Guarini**. There are appraisals and there are appraisals.

Mr. **Woodward**. That is correct, and we all know that, it is a constant problem.

Mr. **Guarini**. No matter how you want to structure the game, at least they would know the rules of the game you have to abide by even if it is arbitrary and it could work quicker and be less expensive, you can manipulate any appraisal any way you want.

Mr. **Woodward**. As I said, we would not be able to support, in fact I think we would have to oppose a formula approach. Nevertheless, if the legislation is going to go forward over our objection, it might be preferable to have a formula than to simply play the appraisal game.

Mr. **Guarini**. Thank you, Mr. Chairman.

Chairman **Stark**. Are there any further questions of the witness? If not, I want to thank you for your presentation and call our next panel, Mr. Kenneth Rosen, chairman of the Center for Real Estate and Urban Economics, from my alma mater, University of California at Berkeley; Ted Dienstfrey, former director of research and planning for the California Housing Council; Stanley M. Taube, past president, National Apartment Association, past president; Douglas Banks, a member of the National Association of Realtors; Harry Pryde, president, National Association of Home Builders.

I have been informed that Mr. Pryde has a 1 o'clock plane and recognizing that, I will ask him to proceed.

STATEMENT OF HARRY PRYDE, PRESIDENT, NATIONAL ASSOCIATION OF HOME BUILDERS, ACCOMPANIED BY EDWARD BECK, TAX COUNSEL

Mr. **Pryde**. Thank you, Mr. Chairman.

My name is Harry Pryde, president of the National Association of Home Builders. Accompanying me is Edward Beck, our tax counsel. NAHB is a trade association with more than 112,000 members representing the Nation's homebuilding industry.

Our testimony covers both H.R. 699 and H.R. 3592, but primarily H.R. 699.

NAHB enthusiastically supports H.R. 699, the Stark and Archer Condominium Cost Reduction Act, as an innovative means of increasing homeownership and providing affordable and adequate housing for the elderly and low-income families.

The changes involve a very small if any revenue loss to the Treasury.

With regard to H.R. 3592, NAHB is concerned about sections 3 and 4, which require a payor to use the cash method of accounting for the purpose of deducting business expenses and interest owed to a related party cash basis taxpayer.

This is intended to prevent a mismatch of income and deductions. NAHB urges the committee to resist the bill and clarify its intent. Legislation should not affect situations involving a seller of property who retains a 50-percent or less interest in a new partnership, and the regulation should not be retroactive. Detailed comments on H.R. 3592 are provided in our written statement.

With regard to H.R. 699, the bill permits an existing apartment owner to convert to condominium and treat the gain at the time of conversion as capital gains. Additional gains upon the sale of the units to individual owners should be treated as ordinary income.

The gain of the capital and ordinary income would be taxed as units are sold. The bill updates the tax law to account for emergence of condominiums. In 1970, only 85,000 condominium units were in the housing inventory, compared to 3.6 million in 1983. In 1981, 26 percent of all first-time home buyers purchased condominiums compared to the overall rental stock. The number of conversions is relatively small. In 1979, 1.3 percent of the rental stocks was converted and three-tenths of a percent in 1982.

H.R. 699 has positive housing, social, and tax policy implications. The bill is good for housing policy, it reduces the cost to purchasers, and makes condominium purchases more affordable. It will assist in the upgrading of current housing stock. The legislation makes good sense as social policy. It reduces pressures on tenants in converted apartment buildings to purchase units or move out. Low-income tenants will have a greater opportunity to purchase condominium units through lower conversions.

The proposal also promotes a sound tax policy. The Tax Code currently encourages the sale of apartments to converters because of so-called dealer provisions which tax the gain from condominium conversions by an owner as ordinary income. Sale to an unrelated converter is capital gains. H.R. 699 will preserve the ordinary income capital gains distinction but eliminate the artificial incentive to sell to converters.

Current tax law is ill suited to the facts of condominium conversion. Typically, owners of apartment buildings will hold the building for many years as long-term investment qualifying for long-term capital gains. The dealer provision discourages owners from converting the unit directly. Instead, to achieve the-long term capital gains, the sale is to a middleman/converter and the pending legislation, of course, would conform the present law to the reality of the situation and prevent an owner to participate in the conversion and pay with the sale of units after conversions taxed as ordinary income.

Concerning revenues, it is unlikely that an owner would convert and pay ordinary income taxes. The dealer rule produces little if any revenue, and under the proposed legislation, an apartment owner who hesitates to sell to condominium converters may convert resulting in greater capital gains realization. This could potentially increase revenues.

In conclusion, we strongly support H.R. 699. It is intended as a revenue neutral way to foster broader homeownership. It eliminates unnecessary tax uncertainties, encourages sales of existing apartment buildings to converters, which often results in extensive pressure on tenants to purchase units quickly or leave. We urge prompt and speedy enactment of 699 as has been recommended by the President's Commission on Housing report, and we would be pleased to answer any questions, Mr. Chairman, you may have.

Mr. FLIPPO. Thank you, Mr. Pryde, for your testimony.

[The prepared statement follows:]

STATEMENT OF THE NATIONAL ASSOCIATION OF HOME BUILDERS, PRESENTED BY HARRY PRYDE, PRESIDENT

Mr. Chairman and members of the committee, my name is Harry Pryde and I am President of the National Association of Home Builders (NAHB). Accompanying me is Alan Feingold, Executive Vice President of Jack W. Blumenfeld and Company, a Pennsylvania multifamily builder, and Edward Beck, NAHB's Tax Counsel.

I am testifying on behalf of the more than 112,000 members of the NAHB. NAHB is a trade association of the nation's homebuilding industry. NAHB's testimony covers both H.R. 699 and H.R. 3592, but is directed primarily towards H.R. 699.

I. INTRODUCTION

NAHB enthusiastically supports H.R. 699, the Stark-Archer Condominium Cost Reduction Act. It is a innovative means of achieving positive housing and social policy objectives. It should increase opportunities for home ownership and assist in providing affordable and adequate housing for the elderly and low-income families. These objectives are accomplished through changes in the tax law which involve a very small, if any, revenue loss to the Treasury.

With regard to H.R. 3592, NAHB is concerned about Sections 3 and 4, which requires a payor to use the cash method of accounting for the purpose of deducting business expenses and interest owed to a related-party cash-basis taxpayer. This provision appears to be intended to prevent situations involving related taxpayers who establish partnerships with different-tax years which are designed primarily to create a mismatch of income and deductions.

NAHB agrees with the goals of the legislation, but is concerned that the drafting is unclear and overly broad. The restrictions apply to resyndications of housing projects in which a cash-basis seller takes back a note from an accrual basis acquiring partnership and the seller remains a partner in the partnership. Often the seller has a de minimus interest in the new partnership.

NAHB urges the Committee to review the language with a view towards clarifying its intent. A de minimus rule dealing with situations involving a seller of property who regains a small interest in a new partnership and a tax avoidance test should be considered. NAHB's comments in detail on H.R. 3592 follow the conclusion of our discussion of H.R. 699.

H.R. 699 establishes a separate section in the Internal Revenue Code which deals exclusively with the capital gains and ordinary income tax treatment of the conversion of existing apartments into condominiums and the later sale of the units to individual owners. The bill permits existing apartment owners to convert to a condominium and treat the gain at the time of conversion as capital gains. Additional gains upon the sale of the units to individual owners would be treated as ordinary income. The gain, both capital and ordinary income, would be taxed as the units are sold.

This legislation has some very positive housing, social and tax policy implications.

The bill is a good housing policy.

It promotes individual ownership by making condominium purchases more affordable and reducing conversation.

It will assist in the upgrading of the current housing stock through renovation as part of the conversion process and through individual owners who purchase unrenovated units maintaining and improving their homes.

It will help to maintain the existing rental stock. As a 1980 HUD study noted, condominium conversions do not significantly reduce existing rental stock. The prospects that apartment owners will be able to convert the apartments into condominium at some future time without the sale to a converter will be an incentive for the production of new apartment units.

The legislation makes sense as social policy.

It reduces pressures on tenants in converted apartment buildings to purchase units or move out and slows the pace of condominium conversion. This is because existing apartment owners will not be required to finance the sale and conversion with short term financing which is typically the case when existing apartments are sold to converters.

With owners being able to sell units to tenants at a "relaxed pace", low-income tenants and the elderly will be able to remain as tenants rather than being pressured to buy.

Low-income tenants will have a greater opportunity than under current conditions to purchase condominium units since conversion costs will be reduced and the need to sell immediately will not be as great. Condominiums will, in other words, be more affordable than under current conditions.

Enhanced opportunity for home ownership will improve neighborhoods and increase the tax base in many localities now face.

The proposal promotes a sound tax policy.

The tax code currently encourages the sale of apartments to converters because of the so-called "dealer" restrictions. These requirements tax the gain on conversion by an apartment owner as ordinary income because of the subsequent sale of individual units. Sale to a converter is capital gains. H.R. 699 will preserve the ordinary income/capital gains distinction but eliminate the artificial incentive to sell to a convertor.

As a technical change, it should involve little, if any, revenue loss.

Looking at the current tax law in more detail, it is directed primarily toward land development and was enacted prior to the development of condominiums. It is ill suited to the facts of condominium conversion. Typically, owners of apartment building will hold the buildings for many years as a long-term investment. They fit precisely under the policy objectives of permitting long-term capital gains.

Therefore, the dealer provisions discourage owners from converting the units directly. Instead, to achieve the long-term capital gains, the sale is to a middle-man converter. The pending legislation would retain the current distinction between capital gains and ordinary income, permitting capital gains up to the time of conversion. It would conform the law to the reality of the situation and permit an owner to participate in the conversion and pay with the sale of the units after conversion taxed as ordinary income.

The legislation should involve very little revenue loss, if any. Currently, it would be highly unlikely that an owner would convert and pay ordinary income tax. Therefore, the dealer rules involve little, if any, revenue gain. Under the proposed legislation, additional sales could occur by owners who hesitated to sell to converters. This would mean greater capital gains realizations. This could potentially provide for a revenue increase.

II. DISCUSSION—H.R. 699

A. The growth of condominiums

The emergence of condominiums is a relatively new phenomenon. In 1970, only 85,000 condominium units were in the housing inventory. By 1983, there were 3.6 million condominium units in the inventory. Currently, 4 percent of all housing units in the United States are condominiums. The condominium market, however, is attractive for many new, first-time home buyers. Thirty-one percent of the new for-sale housing starts in the nation were condominiums or cooperatives in 1982. In 1981, 26 percent of all first-time home buyers purchased condominiums (new or existing) and 22 percent of all home buyers purchased condominiums.

According to data in the President's Commission on Housing report, 366,000 rental units nationwide were converted to condominiums and cooperatives during the 1970-79 period; 71 percent of these conversions (260,000) occurred during 1977-79. Compared to the overall rental stock, the number of conversions is relatively small. In 1979, 1.3 percent of the rental stock was converted to condominiums. In 1982, 0.3 percent of the rental stock was converted to condominiums.

The benefits of condominiums are often hotly debated, particularly in large metropolitan areas experiencing a great number of conversions. This situation has tapered off considerably, particularly with rental vacancies at higher levels in some urban areas.

Some of the benefits of condominium growth and condominium conversion include:

Condominiums offer a new and flexible form of home ownershp for city residents.

Condominiums tend to be cheaper and smaller than single-family homes.

Condominiums fill the gap between rental housing and traditional detached single-family homes, making home ownership possible for a wider range of residents, particularly young, first-time homebuyers and the elderly.

Other broad social benefits from condominiums and conversions include:

Condominiums conform to the changing lifestyles and demographic shifts of American society. With more single individuals, through divorce, age or otherwise, condominiums provide the type of housing which is desired.

Conversions bring rehabilitation of older deteriorating buildings. They provide a way for the private sector to revitalize neighborhoods, while retaining the unique character.

Conversions increase owner occupancy and therefore stabilize neighborhoods.

Condominiums, particularly conversions, increase local revenues. For example, in the District of Columbia, it was estimated that, converted buildings generated 2.3 times the taxes paid by the same buildings previously.

The debate over condominium and condominium conversion is not without its negative aspects. Primarily there is a concern over the decline in the availability of rental space, particularly for low-income families and the elderly. This situation, however, is generally the case in tight rental markets. With the softening of rents in some major markets, this may not be as great a concern as in the past.

Another concern over condominium conversion is the uncertainty which it creates as well as the pressure on tenants to purchase units. Often a converter will seek to turn around a project from rental to condominium within a short period of time. This results from the need to borrow to finance the purchase as well as any rehabilitation which may be made.

B. Principles involved in conversions

There seem to emerge several basic principles which guide condominium conversions.

First, tax considerations dictate the current method of converting an apartment building into a condominium. Owners have no incentive to involve themselves in the conversion process. To do so would trigger ordinary income tax treatment on the entire gain arising from the sale of the units to tenants. Therefore, existing owners, to achieve captial gains taxation, sell to condominiums converters who then resell the units to tenants and the public. The apartment owner may sell to the converter on a installment sale basis, thereby deferring the payment of capital gains tax.

Second, the cost of conversion increases substantially with the use of condominium converters. The sale of the property involves legal fees, transfer tax fees, financing, and a whole array of built-in costs, as well as profit to the converter. The final purchaser of the unit pays these expenses.

Third, conversions do not noticeably diminish the rental stock. In fact, many of the units purchased in a condominium are often re-rented and therefore many units remain in the rental stock. A 1980 HUD study indicated that the net impact of conversions is five units or less per 100 pre-conversion units.

Fourth, condominium converters fulfill a very special role because of the complexities of the conversion process. However, the tax law encourages sale to a converter rather than the owner hiring a converter for a fee.

The dynamics of the conversion process may vary from project to project, but they generally involve a converter purchasing from an owner and financing the purchase or rehabilitation with short-term funds. These funds are typically at higher interest rates than the rates which the original owner was required to pay. Therefore, the converter is under considerable pressure to make rehabilitation changes, if any, and sell the units. This in turn creates pressures on existing tenants to buy or leave.

C. Benefits of H.R. 699

H.R. 699 supports the recommendation of the President's Commission on Housing. Its purpose is to address the negative effects of condominium conversions, particularly the impact on existing tenants, while removing tax rules which virtually mandate the sale of existing apartment units to converters. The valid distinction between capital gains associated with long-term ownership of an apartment building and ordinary income associated with the sale of condominium units would still be retained.

By eliminating the artificial incentives for sale by an owner to a converter followed by conversion, H.R. 699 achieves worthwhile social and housing policy goals of providing more affordable owner-occupied housing for the American population. This goal was recognized as important in the President's Commission on Housing report. The legislation reduces pressure on tenants to buy immediately because the condominium coverter becomes a paid specialist rather than a developer involved in the financial success of the project.

From a tax perspective, the proposal is designed to retain the current law objectives which distinguish between capital gains and ordinary income. But it removes the awkward dealer mechanism for achieving this distinction. The dealer mechanism is replaced with a five year ownership requirement prior to conversion to qualify for capital gains at the time conversion. The amount of gain is based upon an appraisal of the property at the time of conversion.

One aspect of the bill has received attention. This is concern over the use of appraisals as the means for establishing the value at the time of conversion. The use of appraisals, while based upon fairly standard information and techniques, obviously retains an element of subjectivity. There has been some suggestion that the appraisal be replaced with some formula for evaluating the value at the time of conversion.

NAHB has no difficulty in trying to work to construct an appropriate formula. NAHB would be happy to participate in developing such a formula with the Committee and its excellent staff. This provision should not be a major obstacle in the enactment of the legislation.

From a revenue point of view, the legislation should be revenue neutral, and perhaps could increase revenues. The intent of the legislation is not to provide significant new incentives for condominium conversion, but to make the process more rational and logical. The consequences of the legislation may, however, encourage conversions which would previously have not been undertaken. This, therefore, may generate more revenue through greater realizations of capital gains. In addition, the revenue may be collected earlier than under current law in which owners who sell to condominiums converters may do so on the installment basis. Since the owner would be paying tax as the units are sold, this may create more tax revenues earlier than under current law.

A final social and housing benefit emerging from the legislation is that it makes development of rental housing more attractive. With owners seeing the possibility of ultimately converting the units themselves to condominiums, the multifamily housing market may experience an upturn. This would be particularly beneficial in areas in which development of needed rental housing is not attractive because rents are not sufficient to carry debt service and maintenance cost.

III. DISCUSSION OF H.R. 3592 (SECS. 3 AND 4)

A. Background

Under present law, a cash basis taxpayer who has a profits or capital interest in an accrual basis partnership may loan money or sell property to the partnership, receive an interest bearing note in return, and take into account his share of the accrued interest or business expense deductions passed through by the partnership on his Federal income tax return for the taxable year in which the transaction took place. Under the proposed amendments to Section 267 of the Internal Revenue Code of 1954 (26 U.S.C.) set forth in sections three and four of H.R. 3592, such a taxpayer would not be entitled to take into account his share of the interest or business expense deductions passed through by the partnership until they are actually paid. The changes are clearly designed to prevent partner-partnership transactions from taking place that have the principal purpose of generating tax deductions rather than income.

We fully support that goal of the legislation. However, in putting a halt to such tax abuses, the changes, as drafted, also would inhibit the initiation of many typical partnership ventures, such as low-income housing developments.

For example, a partnership might be established for the purpose of constructing or rehabilitating housing for rental to low-income families. To achieve that purpose, of course, the partnership must first acquire appropriate property. When that property is located, its owner may be approached with the offer of a partnership share and an interest bearing note in return for the property. Because housing developments, especially those set up for low-income families, often involve the risk of cash flow problems, the property owner's only incentive to sell his property on credit is the fact that, under present law, he can take deductions currently for his share of the accrued interest or business expenses passed through by the partnership. Without that incentive, it is highly unlikely that an owner would expose himself to the risk of nonpayment. Thus, under the proposed section 267 changes, such projects would have great difficulty getting off the ground.

B. Recommended changes

NAHB submits that the purpose of the legislation, to prevent tax avoidance transactions between partners and partnerships, may be advanced, while at the same time preserving present incentives for undertaking laudable partnership ventures, by making clear in the statute that deductions for interest and business expenses may not be taken until they are paid when the principal purpose for the transaction is tax avoidance. This can be accomplished by inserting the phrase "in a transaction undertaken for the principal purpose of tax avoidance", or similar language, after the word "entity" in proposed new subsection 267(e)(1) (section four of the bill).

In addition to, or in lieu of that language, we believe that for purposes of new subsection 267(e), "related taxpayers", in the case of partnerships, should be limited to those described in section 707(b)(1)(A) (i.e., "a partnership and a partner owing, directly or indirectly, more than 50 percent of the capital interest, or the profits interest in such partnership") rather than to partnerships and persons owning any capital or profits interest in such partnership, as the proposed amendments now provide. Aside from ensuring consistency between section 707 and section 267, that limitation would focus on the real problem of "self-dealing" in the area of transactions between related parties; a transaction involving a partner with a de minimus profits or capital interest in the partnership hardly presents the same opportunity for abuse as a transaction involving a partner with at least a 50 percent profits or capital interest.

Finally, we believe that any changes to section 267 should affect only transactions entered into after their effective date. Such prospectivity is needed because partners who transacted business with partnerships upon the assumption that interest or business expense deductions could be deducted as they accrued should not be penalized.

IV. CONCLUSION

NAHB strongly supports H.R. 699. It is intended as a revenue neutral way to foster broader home ownership. It eliminates current unnecessary tax incentives encouraging sales of existing apartment buildings to converters. These conversions often result in intense pressure on tenants to purchase units quickly or leave. These pressures will be eased under the approach taken by H.R. 699, which permits owners to participate in the conversion process. NAHB urges prompt and speedy enactment of H.R. 699, as has been recommended in the President's Commission on Housing report.

With regard to H.R. 3592, NAHB urges the Committee to review carefully its implementations and clarify its intent by incorporating the changes NAHB has proposed.

We appreciate the opportunity to present our views concerning important tax issues. I would be pleased to answer any questions you may have.

Mr. **Flippo**. Mr. Rosen.

STATEMENT OF KENNETH T. ROSEN, CHAIRMAN, CENTER FOR REAL ESTATE AND URBAN ECONOMICS AND PROFESSOR OF ECONOMIC ANALYSIS AND POLICY, UNIVERSITY OF CALIFORNIA AT BERKELEY

Mr. **Rosen**. Thank you for asking me to come to the hearing. I would like to talk briefly about why I think H.R. 699 is a good idea for everyone involved. In the past several years the housing market has been in a period of major disarray. We have had low levels of new construction and condominium conversions, a sharp slowdown in existing home sales and condominium sales. Probably most importantly, we have had an affordability crisis for first time home buyers.

In order to alleviate this problem we need to have several things. We need to have both different macroeconomic policies and a different set of housing policies. In the area of housing it has been very difficult to find cost efficient policies. They seem to be hard to come by.

My analysis of H.R. 699 indicates that it represents one of the rare cases where everyone will benefit. The first time home buyer will face lower prices, the long-term owner of buildings will face lower tax rates, therefore there will be an increase in the long run of investment in rental housing, and, last, the U.S. Treasury will receive increased tax revenue as these long-term capital gains are unlocked.

What I would like to do is highlight each of these benefits and how they would work. Basically, it seems to me the essence of H.R. 699 is a correction of what I consider a technical error in the tax law. The sale of an apartment building by an owner to one purchaser should be considered the equivalent of a long-term sale of capital assets, so should be taxed as long-term capital gains.

Classifying a long-term investor as a dealer just because of new demographic trends and new demand patterns have made condominium ownership desirable, seems to me absurd. The whole notion of dealer classification concerns active trading in the market and someone who has held a building for more than 5 years is clearly not an active trader in the market. For someone who has bought the building as an investment it seems to me quite clear from a theoretical and technical sense that this person should receive long-term capital gains.

The benefits of correcting this mistake in the tax law I think are substantial. First of all, by eliminating the need to go to a converter/middleman we will be able to reduce the price and cost of the conversion process, estimates that I have done indicate that the cost would be reduced by 10 to 20 percent without having to go through the middleman process. We won't have to go through bridge loans with very high interest rates, that require a risk premium for the converter. This savings, if you believe in market conditions, would be divided between the landlord and tenant depending on each individual market. By eliminating the deadweight middleman we can reduce the cost to condominium conversion and condominium purchasers by 10 or 20 percent.

Also I think instead of having to sell the unit quickly, which is what happens when you have a converter who wants to sell these, the individual landlord will be able to convert the units on a one by one basis depending upon when it is appropriate, when people are moving out.

Also, he will be able to deal better with older tenants and low income tenants. It seems to me by unnecessarily introducing the converter, the converter/middleman, the present tax law makes this process much more disorderly and causes a lot of the problems that we have seen in conversions around the country.

I think the one potential criticism of this entire proposal is the difficulty of administering the appraisal process, and in this regard, it seems to me the simplest way to handle this problem is to have a fixed formula, a fixed formula can be based on roughly what the typical conversion process would produce in terms of short-term ordinary income.

In looking at numbers it appears that about 10 to 20 percent of the conversion results in profit for the converter. So if you were to fix a formula something like 90-10 or 80-20 would be an appropriate formula and would leave the Treasury basically in a neutral revenue position. Now, in fact, that is only a static analysis. If this encourages more conversion, which I think it would and more orderly conversion process we might actually get some additional revenue due to the fact you unlock some of the long-term capital gains.

If I can summarize, it seems to me by passing this bill or a version of this bill, and allowing long-term owners to convert their unit directly, rather than going through a middleman, we will be able to humanize the condo process for thousands of elderly households and at the same time, we will facilitate the ability of first time buyers to get into home ownership which they are prevented from doing today because of high interest rates and the high cost of detached housing.

So, I strongly support this bill. I think it makes good public policy sense and all the parties I think will benefit by this process, and I think it is something that will in the long run be viewed as very positive policy.

Thank you.

Mr. FLIPPO. Thank you, Mr. Rosen.

[The prepared statement follows:]

STATEMENT OF PROFESSOR KENNETH T. ROSEN, CHAIRMAN, CENTER FOR REAL ESTATE AND URBAN ECONOMICS AND PROFESSOR OF ECONOMIC ANALYSIS AND POLICY, UNIVERSITY OF CALIFORNIA AT BERKELEY

In the past three years the nation's housing markets have been in substantial disarray. We have had low levels of new construction and condominium conversion, a sharp slow down in existing home and condominium sales, and an affordability crisis for young first-time homebuyers. In order to alleviate this set of problems, we need better macroeconomic and housing policies. On the macroeconomic side, for the most of 1983 the economy has shown a substantial recovery. Lower interest rates, reduced inflation rates, and stimulative fiscal polices provided the necessary input for a substantial economic rebound. The embryonic recovery, however, is substantially threatened by continued high real interest rates. Without a substantial change in economic policy which results in lower "real interest rates" we cannot expect a sustained recovery in the overall economy and the housing sector. As Table 1 and Figure 1 shows, despite the decline the nominal interest rates, real interest rates are still near record high levels.

In terms of housing policy, the key areas of concern are in providing affordable housing for first-time buyers and renters and in providing adequate incentive for a supply of new housing construction so that the existing housing market will not face a supply-demand imbalance. Cost efficient policies however, to improve these conditions are hard to come by. My analysis of the Condominium Cost Reduction Act (HR699) indicates that it represents one of the rare cases where a change in the law will allow everyone to benefit: The first-time homebuyer will face lower prices, the long-term owner of the building will face lower taxes thus increasing investment in rental units with conversion potential, and the U.S. Treasury will receive increased tax revenues as long term capital gains are unlocked. I will highlight each of these benefits shortly. First, however, I would like to theoretically dicuss the general issue of taxation on condominium conversion projects.

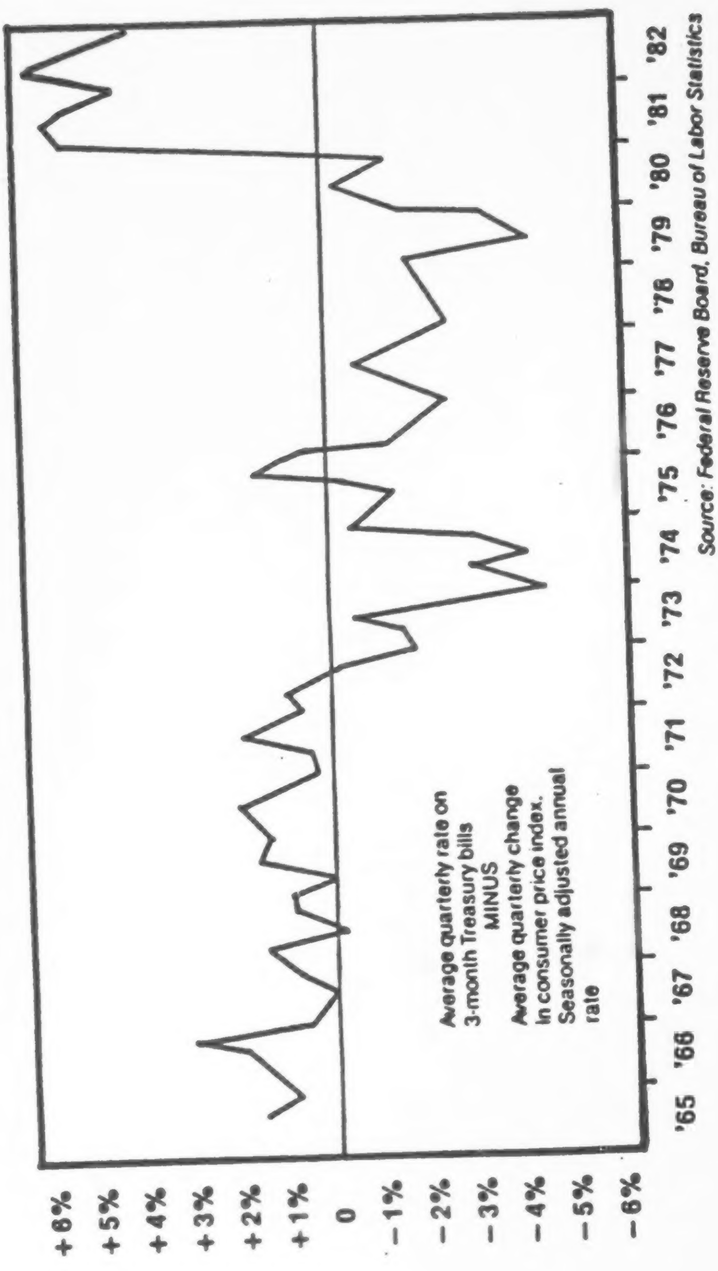
TABLE I.—REAL RATES OF INTEREST BEFORE TAXES

Year	Short-term real rate	Long-term real rate	Percent change in CPI	4-6 mo. commercial paper rate	AAA bond rate
1951	-5.7	-3.4	7.9	2.2	2.6
1952	.1	-.7	2.1	2.3	2.9
1953	1.8	.8	.8	2.5	3.0
1954	1.1	.7	.5	1.6	3.2
1955	2.5	.7	-.4	2.2	2.9
1956	1.8	2.1	1.5	3.3	3.1
1957	.2	2.2	3.6	3.8	3.4
1958	-.3	2.3	2.7	2.5	3.9
1959	3.2	2.1	.8	4.0	3.8
1960	2.2	2.3	1.6	3.8	4.4
1961	2.0	2.5	1.0	3.0	4.4
1962	2.1	2.9	1.1	3.3	4.4
1963	2.3	3.2	1.2	3.6	4.3
1964	2.7	3.0	1.3	4.0	4.3
1965	2.7	3.1	1.7	4.4	4.4
1966	2.7	2.8	2.9	5.5	4.5
1967	2.2	3.1	2.7	5.1	5.1
1968	1.7	2.9	4.2	5.9	5.5
1969	2.5	2.8	5.4	7.8	6.2

TABLE I.—REAL RATES OF INTEREST BEFORE TAXES—Continued

Year	Short-term real rate	Long-term real rate	Percent change in CPI	4–6 mo. commercial paper rate	AAA bond rate
1970	1.8	2.8	5.9	7.7	7.0
1971	.8	2.9	4.2	5.1	7.4
1972	1.4	2.6	3.3	4.7	7.2
1973	1.9	2.4	6.2	8.2	7.4
1974	−1.1	2.4	11.0	9.9	8.6
1975	−2.8	2.0	9.1	6.3	8.8
1976	−.4	1.3	5.7	5.4	8.4
1977	−.9	.3	6.5	5.6	8.0
1978	.3	.7	7.7	8.0	8.7
1979	−.3	1.6	11.3	10.9	9.6
1980	−1.2	2.9	13.5	12.3	11.9
1981	6.6	4.1	8.9	15.5	14.2
1982	7.0	5.8	6.2	13.2	13.8
1983	5.5	5.5	4.0	9.5	11.5

Figure 1



"REAL" INTEREST RATE

Source: Federal Reserve Board, Bureau of Labor Statistics

It seems to me that the essense of HR 699 is the correction of what must be viewed as a "technical error" in the tax law. The sale of an apartment building by a long-term owner to one purchaser or to 200 purchasers (the condo case) should be treated as the sale of a long-term investment asset and so subject to capital gains taxation. To classify a long-term investor as a "dealer" just because new demographic and demand patterns have made individual ownership of apartments desirable is absurd. The whole notion of the "dealer" classification concerns active trading in the market. Clearly an investor who had held a property more than 5 years should not be classified in this category. A long-term capital gain should be dependent on the length of holding period and not the method of sale.

The benefits of correcting this "mistake" in the tax law are substantial. First, eliminating the need for the long term owner to sell to a converter middleman in order to obtain capital gains treatment would reduce the cost of the conversion process by 10–20 percent. It would eliminate the need for short-term funds to finance the conversion and eliminate the premium required for a quick conversion process. This savings would be divided between the long-term landlord and the potential buyer—with of course the market determining the ultimate gain to each party. Clearly, however, the "deadweight" middleman costs would be reduced. In addition, allowing the long-term owner to convert at his/her leisure would cause a more orderly transition process especially for older and lower income tenants. There would be less need for quick sales so the converter could pay off his high rate short-term loans.

By removing the costs associated with the needless introduction of the converter, HR 699 would lower the transaction costs of a conversion and thereby make the market for such transactions more efficient. As a result, the net effect will be to reduce the price of an important housing alternative for first-time homebuyers.

Critics of this plan might claim that it would reduce the supply of rental housing. This is a common statement made by those who are opposed to condominium conversion generally. This proposed change in the tax laws would, in my view, only slightly increase the rate of conversion of rental apartments. The potential loss of rental units would be more than made up for by the increased incentive for the construction of rental units. By lowering the tax rate on condo conversion projects, to make it equivalent to the rate on other long term capital asset sales, it will encourage an increase in investment in new and used rental housing with condo conversion potential. In addition, because conversions could be done on a unit by unit basis rather than a wholesale basis, there should be a more orderly and less disruptive process. This will especially benefit elderly households in a large project.

In terms of tax revenue to the Treasury the effects will also be positive. In the static situation of no additional conversions, lowering the tax rate might reduce revenues by 5–10%. In a dynamic sense however, allowing the conversion to be fully treated as a long-term capital gain would unlock some additional long-term real estate gains and so increase tax revenues. The net tax effect depends on the responsiveness of demanders and suppliers, but a net increase of 10–20% in aggregate revenues is quite possible.

The only problem I see with the bill as proposed is the administrative difficulty associated with finding the division between capital gains and ordinary income on a case by case basis. From an administrative perspective HR 699 would be far easier if Congress could set some fixed division between capital gains and ordinary income. Assuming that the converter is now making somewhere between 10 and 20 percent of the retail selling price of individual units, Congress may wish to make the bill easier to administer by fixing the ordinary income share of the gain at 10–20 percent.

Finally, let me conclude by saying that this bill, allowing long-term owners to directly convert their buildings rather than going through converter middlemen will "humanize" the condo conversion process for thousands of elderly households, while at the same time facilitate the purchase of a key source of owner-occupied housing for first-time young buyers.

Mr. **Flippo**. Mr. Dienstfrey.

STATEMENT OF TED DIENSTFREY, FORMER DIRECTOR OF RESEARCH AND PLANNING, CALIFORNIA HOUSING COUNCIL

Mr. **Dienstfrey**. Mr. Chairman, there are a number of issues I would like to briefly comment on. In the past few days, while discussing H.R. 699, the issues seemed to divide into two types of themes, one dealing with tax equity and one dealing with social policy. I don't fully understand or appreciate the internal working and internal logic of the tax code and leave the issues of tax equity to other people. My interest in the bill originally and my interest in it now has to do with social policy.

I believe that H.R. 699, if passed, a long-term owner will be able to respond to the market demand for home ownership in an orderly manner with far less disruption of tenants. I think that is important.

The intent of the bill is to be revenue neutral without, we hope, creating an administrative nightmare. If we hold market demand constant and interest rates constant and local regulations constant, we probably could predict revenue implications with great precision. In the real world, we will have to make some reasonable approximations.

I was impressed by the Treasury statement where they said that the intent of the bill had some technical merit but they did not like the proposed means of achieving that goal of being revenue neutral. I would support the movement toward some simpler formula or some percentage formula, which in some cases will be high and in some cases will be low.

The issue by some people, though it has not been raised yet today, is how long the owner should have the capital gains provision. If the intent is to permit an orderly conversion that minimizes displacement, then there ought not to be any clock. At the very least, the period of time that local jurisdictions provide for mitigation of tenant displacement, that is, that tenants in place have extended leases with various rent controls should not be counted against the clock.

Finally, a comment on one of the points in the Treasury statement, they were concerned that H.R. 699 would allow the taxpayer to defer recognition of the capital gains portion of his profit. This is done currently under an installment sale; this is not a change in the current law.

If you have any questions, I will be glad to try to respond.

Thank you.

Mr. FLIPPO. Thank you very much.

[The prepared statement follows:]

STATEMENT OF TED DIENSTFREY, CALIFORNIA HOUSING COUNCIL

Mr. Chairman and Members of the Sub-Committee on Select Revenue Measures:

My name is Ted Dienstfrey and I am currently a planner and analyst for the firm of Gerson Bakar and Associates which is a major real estate development firm in the San Francisco Bay area. Prior to my employment at Gerson Bakar and Associates, I was Director of Research and Planning for the California Housing Council which is a state-wide trade association of major apartment owners and managers. I have a Master of City Planning degree from the University of California, Berkeley.

I think the history of how we have come to be here today to discuss the pros and cons of the Stark-Archer Condominium Cost Reduction Act deserves some attention. It is important to first try to understand what objectives we are trying to achieve. And if after all discussion we agree on objectives, we can work together to figure out how to technically carry out our objectives.

A few years ago I was in the office of the National Housing Law Project which has been a federally funded legal organization that provides help to the various local legal assistance programs funded by the Legal Services Corporations. Over the years we have occasionally discussed the issues of rental housing from their perspective of a legal organization fighting landlords and my perspective of how, as a society, do we most effectively improve housing opportunities.

After a long discussion, where both sides agreed that managing rental housing was a complex and thankless task, one of the Housing Law Project lawyers asked me why owners didn't sell their units to tenants. I replied that while that might make good social policy, the tax laws were such that owners are strongly motived by the law not to sell units directly to tenants. The lawyer said change the law. I said I didn't know how to do that. He said find out. And here we are today.

Let me try to explain what the current law is and, more important, the social problem with the current law. Under current tax law, if an owner who has a long term capital asset in a rental wants to sell individual units to tenants or other home buyers, the owner will be taxed at an ordinary income rate. Given the inflation of the last decade, most this ordinary income would be taxed at 50 percent.

Now if the owner sells the property to a professional converter and this new player sells individual units, the owner's sale would be taxed at a capital gains rate or essentially 20 percent of the gain. The converter's profit, if any, is taxed at ordinary income. I used the words "if any" advisedly. In the late 70's at the height of the inflation, inflation of and by itself would generate fairly high profits to the converters. As the inflation has eased and as interest rates have stayed high, many converters are indeed not making profit.

From the above analysis, I think you can see why most owners would decide to place an independent converter between themselves and the individual buyers. The question we raise today is whether or not the current tax laws results in good social policy. I would argue, and I believe my friends at the Housing Law Project would argue, that existing tenants and first time buyers are ill served by the current tax law.

First let us talk about the whole issue of conversions. Is conversion of rental apartments to individually owned units in the public interest? By and large, I believe it is. It has been a long term goal of Congress and of the voters in general to encourage individual home ownership. Most American households want to own their home. The individual deduction of mortgage interest and property tax is clearly designed to encourage this goal. In periods of high inflation, individual home ownership is critical to the consumer.

Is a multi-family unit a suitable unit for individual ownership? Quite frankly that is not a suitable question for you or me. That is a question for the market place. If large numbers of households want to own individual units in a multi-family building, as seems to be the case, who are we to argue against these consumers?

However, there are real public policy issues concerning the conversion of existing multi-family units. Most buyers are not in a position to fully evaluate the quality of the product they are buying or, quite frankly, to fully understand their rights and obligations in the home owners association which manages the multi-family structure after conversion. The issues of public disclosure of the quality of a structure or the workability of an association are legitimate public concerns. They are, for the most part, being addressed by local and state governments and state courts. Furthermore, since the sale of individual housing involves individual financing, local financial institutions in the private sector tend to demand standards necessary for prudent lending. There were, indeed, buyer protection problems when conversions first occurred, but through the genius of local government most of the problems seem to be behind us. There really seems to be no need for national solution that Congress must impose.

This issue which is often raised is that conversion decreases the supply of rental housing and therefore hurts, tenants. In the long run this is a phony argument. Certainly a converted rental unit decreases the supply of rental housing. However, our experience is that 20 to 50 percent of converted units are not owner occupied but are still part of the rental supply. Now, decreased by conversion, one must remember that the overall demand for rental units the decreased. In the long run, when the various moves have occurred the same relative equilibrium will be reestablished.

The problem is what happens in the short run, as has been indicated; current tax law motivates a long term owner to sell to a converter. The converter has a new, much higher debt service. The converter, therefore, is motivated to sell to existing tenants or to move out the existing tenants and sell to new third parties. Thus, the problem and needless fear of displacement. In a tight rental market, suddenly forcing several hundred residents to move creates a needless problem.

If H.R. 699 passes, an owner would be able to sell or convert units on turnover. The question now raised is shouldn't the owner receive capital gains only if existing tenants receive extended leases. The answer is whether the specific mitigating measures dealing with displacement should be dealt with at a local level or at the federal level. I can assure you that California local governments will handle this issue and that as far as California is concerned there is no need to put specific tenant displacement protection in the federal tax code. I am sure that the other states are equally competent to address this issue.

There are two additional consumer benefits to H.R. 699. First, given the long term owner's position, the long-term owner could, in many cases, self finance individuals sales. Thus, homeownership could be extended without the initial need to go to the crowded credit market. Existing owners, in many cases, would offer below market rate financing. Under current tax law, such financing is prohibited because it runs the risk of "attributing" the conversion to the owner and thus "triggering" ordinary, 50% tax collection on all sales.

Next, H.R. 699 would reduce the cost of converting units. This reduced costs results from eliminating the converter's profit and converter's cost. How much of the reduced costs will go the owners and how much to the first time buyers? That is a question that cannot be answered in every specific situation. However, it seems reasonable to me to believe that if the cost of a product is reduced, more of that product will be produced, and that at least part of the reduced cost will pass on to the consumer.

We next come to the issue of the revenue impact of the proposal. It is the intent to try to draw up a bill that is essentially revenue neutral without creating an administrative nightmare. The bill as currently drafted proposes that the split between ordinary income and capital gains be determined by an appraisal. Upon reflection the appraisal approach seems to be an invitation to endless argument and needless litigation. Assuming you and your colleagues believe that consumers would benefit by passage of H.R. 699, you ought to try to give the owners and the IRS rules that are relatively simple to administer.

After much discussion, it seems that a formula would achieve the desired results and, at the same time, limit litigation and arguments. The formula proposed is:

(1) If within two years prior to the first sales, less than 5 percent of the initial estimated sales price is capitalized, the entire gain is capital gains.

(2) If an amount between 5 and 25 percent of the initial sales price is capitalized, that same percent of the gain is ordinary income.

(3) If more than 25 percent is capitalized, the entire amount is ordinary income because, in effect, you do not have a long term owner.

The question has come up of whether sales by the owner should take place within a limited period in order to obtain capital gains. If the goal of the Housing Law Project lawyers were to mitigate needless tenant displacement, one has to be very careful about putting any time limit on the owners capital gains position. At the very least the clock on losing capital gains for any unit should not start as long as that unit is restricted by local government from being sold. This means that if local government gives existing tenants an extended lease as a condition of conversion approval, the Federal government should not try to undercut such local policy by limiting the capital gains period for that individual unit.

Mr. **Flippo**. Mr. Taube.

STATEMENT OF STANLEY M. TAUBE, PAST PRESIDENT, NATIONAL APARTMENT ASSOCIATION

Mr. **Taube**. Thank you, Mr. Chairman and members of the committee.

My name is Stanley M. Taube, president of Lanvesco Corp. in Minneapolis, Minn. Our business is the owning, managing and developing of multifamily units and our principal business until very recent times has been the conversion of rental apartments into condominiums.

I think, Mr. Chairman, that perhaps I can offer a perspective on this bill that perhaps no one else on the panel can because I am solely involved today in either the development of new condominiums or the conversion or rental of condominiums.

I am here today as a past president of the National Apartment Association, which represents 45,000 owners, developers, managers, and builders of rental apartments throughout the United States.

I have seen as a converter that condominium conversions have offered to the entry-level housing person the most affordable opportunity to own a home. I have seen conversions offered to the elderly, many opportunities to stake their roots and not sit at home worrying about rent increases, et cetera, that they finally can own the home that they have dreamed of owning, or that the entry-level person can own a home he has dreamed of owning. And you know, there is certainly a social benefit involved.

But I have also seen, quite candidly, Mr. Chairman, that conversions can cause displacement. That is a fact and I have to acknowledge that fact.

I think that one of the real benefits of this bill is the fact that, as an owner of a rental building who might convert to condominium, there is no question in my mind that we would minimize the displacement by having the owner convert his own building into the condominium.

Let me tell you very briefly why. Let me share with you a couple of case histories in which my company has been involved.

I owned, as a partner, a 144-unit apartment complex in what I will call a middle-income suburb. All of the partners that owned the building wanted to convert the building to a condominium for a variety of reasons. Because of my experience in condominium conversion, I was the logical partner to form the conversion for the group.

The group decided that it could not convert the building into a condominium because of the ordinary income tax consequences. So, as a result, the group sold the building to my corporation as an arms-length transaction and received capital gains.

I then converted the building in my corporation. We earned a profit and paid ordinary income tax consequences on the incremental value. Of the 144 units, only two units were purchased by residents in the building. The remaining 142 were purchased by outside buyers.

If time permitted, I could go through and give you all of the additional costs that the conversion incurred as a result of the fact that it had to be sold to a third party converter, but the most substantial is the fact that as a converter, I had to go out and acquire original financing at 2 percent over prime to finance the acquisition of the building, the capital improvements and the whole entire holding period.

I paid a different commission to my sales people for outside sales than I do for in-house sales because the in-house sales are a captive audience and much easier to acquire.

The bottom line, Mr. Chairman, is that it is clearly more expensive to convert when you use a middleman converter.

Frankly, I had somewhat of a dilemma when the members of my association asked me to testify in support of this bill, because as a converter, I obviously have the least to gain from this bill. Nevertheless, the association felt that I had the most experience and could perhaps share with you more factual knowledge on what this bill would do.

One other case history, very briefly: I am now in the middle of a conversion where the target market is primarily entry level buyers. We are having a difficult time with the conversion due to high interest rates, et cetera, but the bottom line again is that our product in today's market is priced too high because of all the costs associated with the conversion.

The owner of the building from whom we bought the property was an experienced real estate developer and had the ability to convert the building himself, but here again, tax consequences dictated that he not do that.

I listened with interest to Treasury's concern about the tax implications of this bill. It is obvious that the Treasury cannot enthusiastically oppose the bill. A formula, Mr. Chairman, a formula can really simplify this bill.

When I buy a property for conversion, I generally pay about 55 percent of what we consider the sell-out to be. We incur about 25 percent in conversion expenses, and my target goal is about 20 percent. We rarely hit 20 percent. We are generally in the 10 to 15 percent range. We on occasion hit 20 percent.

Frankly, I think that whether I sell the building to you, one person, or I sell it to 100 people, capital gains treatment is warranted. But in fact if there is concern about the implication to the Treasury, it is a very simple matter to simply say 80, 85 or 90 percent of the gain is capital gains and the other 10 or 15 percent is ordinary income. This type of formula, in effect, mirrors what happens today in the market.

Why make something that is really simple complicated?

I thank you, Mr. Chairman, for the opportunity to testify today and I thank you for your support of this bill.

Mr. FLIPPO. Thank you, Mr. Taube.

[The prepared statement follows:]

STATEMENT OF STANLEY M. TAUBE, PAST PRESIDENT, NATIONAL APARTMENT ASSOCIATION

Mr. Chairman and member of the subcommittee, my name is Stanley M. Taube and I am President of Lanvesco Corporation, a multi-family housing firm based in Edina, Minnesota. Our firm develops and builds both apartment and condominium units in addition to converting many apartments to condominiums in the Twin Cities area. I am appearing here today as the Past President of the National Apartment Association, a trade association represting more than 45,000 owners, builders, developers, and managers of nearly two million apartment and condominium units across the country.

On behalf of the NAA, I would like to take this opportunity to thank you, Mr. Chairman, for sponsoring H.R. 699, the Condominium Cost Reduction Act, and for holding this hearing today. Our Association stands ready to help you in your efforts to get this bill enacted into law.

As someone who has been involved in the building industry for years, I am aware that for most people the dream of homeownership often begins with the least expensive form of housing. Because of the high interest rates and land costs which have plagued our country during the last several years, condominiums have often become the most affordable ownership housing that is available today.

Because of the generic capital gains and "dealer" rules, the current tax laws discourage sales to tenants and encourage sales to converters, like myself. Under the dealer rules, if an owner sells more than 5 units of a project a year to tenants, he is considered a "dealer" and must pay oridnary income taxes on his entire gain above his present basis. To avoid this significant tax penalty, owners sell the building as a whole to a converter and the owner is granted all capital gains on his profit. Because of this stiff tax for sales to tenants, virtually all condominium conversions are accomplished with the involvement of professional converters. In virtually none of the cases do owners convert the building themselves and pay taxes at ordinary income tax rates.

While condominiums are viewed as providing homeownership, they have, I believe, been unfairly painted as the newest villain in the multifamily industry. The HUD study, "The Conversion of Rental Housing to Condominiums and Cooperatives," shows that for every 100 rental units converted there is a decrease on only 5 available rental units from the housing market. In other works, the study goes on to point out that "when changes in demand and supply resulting from conversions are juxtaposed, the effect on the rental market is considerably less than the total of all units converted."

However, we are not blind to the fact that conversions by professional converters have had some negative impact on the housing market because of insensitive converters and present tax laws. This bill, by cutting out the middleman converter, makes conversions a much more humane and cooperative venture between the owners and the tentants. In the typical conversion today, the converter buys out the owner with short-term money usually pegged a few points above the prime. Because of the high carrying cost and the fact that the converter has to pay ordinary income tax on any of his gain, makes it necessary for him to sell the units as fast as possible to limit his carrying charges and overhead. Many times the converter upgrades the units so that he can charge a high enough price to pay for his expenses and cover his substantial risks. As prices increase to cover these costs, many of the current tenants will find it impossible to purchase their present units. My company estimates the cost of conversion is increased by at least 25 percent by the converter's involvement.

Our Association believes that if current tax laws did not discourage apartment owners to convert the building themselves, the condominium market would work quite differently. H.R. 699 would provide that if an owner converts an apartment to a condominium after holding the building for five years or more, the amount of profit realized by virtue of gain the value of the building as a residential rental property is to be taxed at capital gains rates and any profits realized beyond that at ordinary income rates. We estimate that there will be little revenue impact to the Treasury with this change to the tax code.

Under H.R. 699, conversions could be a lot less burdensome to the resident as well as make converted units more affordable. There will be no short-term loan needed to purchase the building or a need to upgrade the units to cover the short-term high risk cost, normally associated with conversions under current law. In fact, we see H.R. 699 as allowing the typical owner of a building to pay down a significant percentage of the mortgage; and, his rents will likely cover his mortgage payments and expenses. At the same time, the economic incentive to hold on to the property will have decreased because his depreciation deductions will have significantly decreased.

Within the confines of the present tax law, the owner is encouraged to sell the project but not directly to an individual who currently lives in the unit. However, H.R. 699 would provide that the owner could sell the units to his tenant and make a fair profit without incurring the high short-term costs and risks that the converter takes. The owner would also save considerable costs by selling the unit to the tenant because he would avoid large real estate brokerage costs and other transaction costs associated with bringing in new owners. The owner, could therefore, sell the unit at a significantly lower price—one that the present tenants would be more able to afford. There would be less need to upgrade the unit beyond the affordability of the current residents. This will lead to less displacement because it will eliminate the need to move the non-buying tenants out quickly. In addition, the owner will find it easier to comply with many local restrictions which require extended lease terms for current tenants, since he is already carrying the building as a rental project without a large short-term obligation.

This example of how we see conversions working under H.R. 699 coincides with a case presented in a book entitled Condominiums: The Effects of Conversions on a Community. This book is a study conducted by Harbridge House, an international management consulting organization, on condominium conversions in Brookline, Massachusetts. The authors discuss three models for developing a condominium which different developers have followed in Brookline. The model which closely follows the case I presented, is described as Model C in the excerpts attached to my testimony as Exhibit A and characterizes conversion projects undertaken by the landlord of the building.

As presented in the study, "Landlords who followed this strategy priced their units lower than other developers with respect to selling price and sales price/rent ratio. This possible underpricing holds even when size and rent are held constant. The Model C strategy is much closer to the low price/fast sellout end of the strategy spectrum and may therefore reflect a low risk tolerance on the part of the landlord." Under this model, the authors found that "tenants in the converted building are likely to experience a more relaxed conversion process—that is, less intense pressures to decide quickly to buy or move out." The study does point out however, that only a "small proportion of all units have been converted in acordance with this model's strategy." We believe that the authors found that this model was so rarely used precisely because the current tax laws treatment of conversions.

I understand that in meetings which have taken place over the last several months, one of the issues that has been raised by your staff and the staff of the Joint Committee on Taxation, is the current language in the bill which would require the use of appraisals to determine the capital gain portion of the income from conversions. In order to minimize revenue impact and in recognition that an owner should not get a capital gain windfall, H.R. 699 currently proposes an allocation between capital gain and ordinary income, the former measured by the appreciation in the building's value as rental property and the latter by any gain beyond that. The intent of this split is to mirror roughly the tax consequences of a transaction with converter involvement so there will be no impact to federal revenue. However, there have been concerns raised over the use of appraisers for determining the value of the building as a rental structure.

An alternative we would like the Committee to consider is a "safe-harbor" formula by which certain aspects of each transaction would be measured in order to determine the split between capital gain and ordinary income. This porposal would proceed on the assumption that the amount taxed as ordinary income should bear a relation to the amount the owner expends before ordinary expenditures in improving the units for the purpose of selling them as condominiums. The amount would be expressed as a percentage of the selling price. What is used to represent the owners "improvements" are capital expenditures on the building during the two year period before sales begin.

The gain however on all other sales could be determined under a fixed formula that would eliminate the need for appraisals. For instance, if capital expenditures in the two years before sales begin are less than 5 percent of the selling price, all the gain is capital gain. This result can be justified on the grounds that a certain level of capital investment is ordinary in the operation of a rental property, and that expenditures at that level should not be regarded as in contemplation of conversion. If capital expeditures in the two years before sales begin fall between 5 percent and 25 percent of the selling price, then that same percentage of the gain is ordinary income and the balance capital gain. Where capital expenditures reach more than 25 percent of the selling price, all the gain is treated as ordinary income.

While we believe that H.R. 699 will significantly decrease the tenant displacement that often occurs when conversions take place, we think it is important that there be an additional provision added to the bill if this legislation is to encourage sales to present tenants. Therefore, we would suggest that the Committee consider adding language to the bill that would provide that all of the gain on sales to those who are tenants in the project being converted, and who were tenants for a period such as one year immediately proceeding the conversion, be treated as capital gain. This would give the owner a significant incentive to reduce the cost and to further discourage displacement. This, of course, would have some marignal cost to the Treasury. However, we believe that amount would be out-weighed by the social benefit of increased affordability of ownership housing.

We believe the special treatment afforded the gain on sales to tenants is in keeping with the rationale for the formula. The units which an owner would sell to tenants are not ordinarily improved, but sold as is. In addition, in keeping with the tax policy in H.R. 699, this proposal would provide incentives to owners to sell to tenants and would encourage conversions only with necessary improvements, thus keeping costs down. Therefore, the housing policies in H.R. 699 relating to tenant displacement would be maintained under this proposal.

NAA strongly supports this bill and has included it as one of our legislative priorities for 1983. By allowing long-term owners to directly convert their building rather than going through a converter will alleviate the fear and uncertainty among existing tenants, especially the elderly, while at the same time facilitate the purchases of a key source of owner-occupied housing for the first-time homebuyer. We would urge your Committee to act favorably on this measure.

Mr. TAUBE. Mr. Chairman, this concludes my statement. Thank you for giving me the opportunity to present the views of the National Apartment Association to this Committee. I would be pleased to answer any questions you may have.

EXHIBIT A

CONDOMINIUMS

The Effects of Conversion on a Community

JOHN R. DINKELSPIEL
JOEL UCHENICK
HERBERT L. SELESNICK

Harbridge House, Incorporated

Auburn House Publishing Company
Boston, Massachusetts

Moreover, if the developer begins marketing the units before the purchase date, some of the tenants may move and the landlord will have to rerent the vacated units. The seller can minimize this risk by restricting the buyer's options through a tightly drawn purchase and sale agreement of short duration.

In sum, the pros and cons of a landlord selling to a developer or to another landlord are mixed. A more basic question, however, is whether the landlord wishes to sell the building at all. We found no evidence that any substantial number of rent controlled buildings are now on the market in Brookline. It appears that most landlords in Brookline, after weighing the alternatives open to them, still prefer to continue to rent their buildings. It can be argued that this may be because their income from renting and the other satisfactions of ownership (for instance, being able to pass on a sort of "living trust" to their children) meet their needs. Or, as one developer suggested, it may be because rent control has depressed the value of rental buildings and landlords do not want to sell at prices they consider to be below the buildings' real value.

Regardless of what landlords' actual reasons are—and reasons certainly vary among landlords—it does not appear that the desire of landlords to sell their buildings is a major force in pushing up the rate of conversions. As discussed in Chapter 7, the availability of developers with the financial ability and range of skills necessary to convert buildings successfully, the assistance offered by banks, the rising demand for the form and price of home ownership represented by condominiums, and the effects of conversion regulations seem to be the most significant factors influencing the rate of conversions.

Three Models of Conversion

The foregoing discussion delineated in qualitative terms the elements of the conversion process and the risks and resources of conversion participants. Our investigations revealed that developers of different sizes and with different resources combine these elements in characteristically different ways. This section presents in quantitative terms three models for developing a condominium which different types of developers have followed in Brookline. The data for each model are drawn from information provided by a number of developers and

Table 3.2 Alternative Development Models

Model	*Number of Units per Building*	*Selling Price per sq. ft.*	*Unit Selling Price*	*Pre-Conversion Rent per Month*	*Sales Price/Rent Ratio*
Model A	60	$43.00	$44,500	$385	116
Model B	12	$26.00	$41,200	$295	139
Model C	15	$31.00	$34,500	$350	100
Average of Sample of 21 Buildings (for comparison only)	27.6	$36.36	$39,664	$335.42	118.25

banks in relation to specific buildings they have developed or financed. We have tested the reliability of these information sources by comparing the numbers from different sources for the same building and by our own financial analyses of typical conversion situations.

The three models we describe, therefore, are firmly founded in verified empirical data. At the same time, they do not replicate the experience of any one developer or any one conversion. Each model is representative of a different general approach to converting an apartment building to a condominium. Most of the conversions in our sample of 21 are explained by one or the other of these models. Table 3.2 summarizes the data for all three models.

Model A

Model A characterizes condominium conversion projects that require a large equity investment for building acquisition. Such conversions, which usually occur in buildings containing a large number of units (in our sample, 40 or more units), require substantial front-end equity from the developer—that is, a substantial investment of the developer's own capital. The few developers who undertake these high-cost conversions are well capitalized and have relatively easy access to loan funds.

Based on our data for this model, the typical number of units per building was 60; the typical unit selling price per square foot was $43; the typical unit selling price was $44,500; the average rent for a unit before conversion was $385 per month; and the average selling price of a unit represented 116 times the previous monthly rent of the unit. Model A has, relative to the other models, the highest selling price per square foot, the highest unit selling price, the highest pre-conversion rent per month, and a mid-range sales price/rent ratio.

The income statement on page 37 shows the typical financial considerations of a developer following Model A.

Model A

Sales price per unit		$44,485
Costs:		
Acquisition		$24,912
Conversion		$10,676
TOTAL COST		$35,588
Profit before tax (no broker's fee included)		$8,897
Gross sellout price	= 100%	
Acquisition	= 56%	
Conversion	= 24%	
Profit	= 20%	
Developer's Equity Investment	= $16,895	
Return on Equity	= 21.5%[*]	

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[*] This percentage represents an internal rate of return on the developer's own funds, assuming no recapture of investment and profit for two years. The rate of return on equity is directly related to the proportion of the total investment in conversion that is the developer's money. Profitability is computed on the total investment base—the developer's funds and all other invested funds in the conversion, or all debt and equity. Most real estate transactions have a comparatively high return on equity because they have a narrow equity base.

Generally, Model A conversions involve the acquisition of high rent units in relatively large buildings that require little more than cosmetic rehabilitation. Developers using this strategy invariably have been the owners of a large amount of rental property. Because of their financial strength, these developers can follow a slower pace of conversion. In addition, the tenants in the building being converted are among the most affluent renters in the Brookline market. This combination of slow pace and affluent tenants is highly correlated with a large number of presales. The need for little rehabilitation and the high number of presales result in a low risk albeit expensive conversion. Selling price, as measured by the sales price/former rent ratio, is slightly below average for our sample of 21 converted buildings. Thus, on the low price/fast sellout—high price/slow sellout spectrum, the Model A strategy falls about midway between the extremes. Based on our analysis, we believe that this strategy is by far the one most frequently employed in Brookline since 1977.

Model B

Model B characterizes condominium projects that require a greater than average rehabilitation investment. Building acquisition, as a result, is not the only large cost facing the developer; rehabilitation is also a major cost. These conversions tend to be undertaken by developers who either are contractors themselves or are linked closely with contractors.

Our data show that for Model B the typical number of units per building was 12; the typical selling price per square foot was $26.00; the typical unit selling price was $41,200; the typical rent before conversion was $295 per month; and the sales price/rent ratio was 139—the highest for any model. The following income statement shows a developer's typical financial considerations in this strategy.

Model B

Sales price per unit		$41,444
Costs:		
Acquisition		$18,649
Conversion		$14,505
TOTAL COST		$33,154
Profit before tax (no broker's fee included)		$ 8,290
Gross sellout price	= 100%	
Acquisition	= 45%	
Conversion	= 35%	
Profit	= 20%	
Developer's Equity Investment	= $7,771	
Return on Equity	= 26.6%*	

* This percentage represents an internal rate of return to the developer's own funds, assuming no recapture of investment and profit for two and three quarters years.

Generally, Model B involves the acquisition of low-rent units in relatively small buildings that require more extensive rehabilitation than Model A buildings. This is reflected in the high sales price/rent ratio of the converted units when they come on the market. Model B developers borrow a greater proportion of the funds needed for projects than Model A developers. The need for extensive rehabilitation and the concomitant difficulty of achieving a high number of presales indicate that the Model B strategy is high in risk because the developer is subject to cost overruns and time schedule interruptions. The return on investment to the developer, however, is also higher. It is probably this strategy more than any other that results in tenant harassment, partly because tenants are disturbed by extensive rehabilitation work and partly because of the developer's pressing need to sell out quickly to control risk. The Model B strategy probably accounts for less than one quarter of the converted units in our sample.

Model C

Model C characterizes conversion projects undertaken by the landlord of a building. This landlord, however, is not the stereotypical owner of one building. Rather, from our investigations, such an individual is actively involved in the real estate market. This situation is distinctive because building acquisition is not a factor the developer must cope with before undertaking the conversion.

Our data show that for Model C the typical number of units per building was 15; the typical selling price per square foot was $31.00; the typical unit selling price was $34,500; the typical rent before conversion was $350 per month; and the sales price/rent ratio was 100. Landlords who followed this strategy priced their units lower than other developers with respect to selling price and sales price/rent ratio. This possible underpricing holds even when size and rent are held constant. The Model C strategy is much closer to the low price/fast sellout end of the strategy spectrum and may therefore reflect a low risk tolerance on the part of the landlord. While this strategy is similar to that of Model B, the Model C developer is not subject to the same intense financial pressure because the developer makes no new investment of funds to acquire the building. As a result, tenants in the converted building are likely to experience a more relaxed conversion process—that is, less intense pressures to decide quickly to buy or move out.

Data are insufficient to construct a reliable income statement for Model C. We believe only a small proportion of all units have been converted in accordance with this model's strategy.

Summary

The purpose of this chapter has been to describe fully the conversion process as it is carried out by the developer and his financing sources. The risk factors a developer must take into consideration in converting a building are summarized below.

Mr. FLIPPO. Mr. Banks.

STATEMENT OF DOUG BANKS, ON BEHALF OF THE NATIONAL ASSOCIATION OF REALTORS AND THE REAL ESTATE SECURITIES AND SYNDICATION INSTITUTE

Mr. BANKS. I am Doug Banks and I am appearing on behalf of the National Association of Realtors and its affiliates. I am a partner in the International CPA firm of Touche Ross & Co. and a member of the American Institute of CPA's and serve on the partnership taxation subcommittee. I am also the chairman of the Touche Ross committee on taxation and real estate.

I appear today on behalf of the nearly 600,000 members of the National Association of Realtors and the Real Estate Securities and Syndication Institute, and we appreciate the opportunity to express support for H.R. 699, and to make some comments with regard to H.R. 3592.

The concepts embodied in H.R. 699 have been supported by the association for several years, and this legislation, we feel, would correct the current discrepancies that support the taxation of direct apartment building condominium conversion and those conversions made by professional condo converters.

Under the current law, an apartment building owner who wishes to convert the building to a condominium is encouraged primarily by the Tax Code to sell the entire building to a professional middleman who then converts the building to a condominium. This sequence of events allows the apartment owner to treat the result as capital gains.

On the other hand, if the owner converts the building directly himself without the use of the middleman, the gain is considered ordinary income and is taxed at a much higher rate.

This tax discrepancy encourages apartment owners to convert through the use of professional middlemen, and consequently could result in increased prices of the condominium units and possibly displace elderly tenants and others living in the building.

We believe that H.R. 699 would remove the penalty which apartment building owners currently suffer from different conversions by allowing capital gains treatment even if the owner converts the building indirectly himself.

The National Association of Realtors supports this legislation because it will remove a discrepancy on similar transactions and because the bill simultaneously will help to expand, we believe, the supply of affordable housing by removing unnecessary costs involving using the converter middleman.

We commend the committee for sponsoring this legislation and for holding this hearing today.

We would also like to comment on the H.R. 3592 and we have the following comments which we believe are relevent.

The National Association of Realtors and primarily the Real Estate Securities and Syndication Institute, which itself constitutes approximately about 3,500 members of the group, are involved in real estate syndications and are concerned with the legislation because of the provision that would amend the related party rules and require that the payor be based on a cash basis method of accounting for purposes of deducting business expenses and interest owed to related cash basis taxpayer.

We would suggest that the related party rules being proposed under this legislation be amended to require a 50-percent ownership interest test. Our analysis would show that the current legislation discriminates against doing business as a partnership where a subchapter S corporation in favor of corporations, because, as currently proposed, the related party rules require any amount of interest owned in a partnership and only 2-percent ownership of a sub-chapter S corporation while requiring 50 percent for corporations.

We feel that the current language would also have a major impact on the syndication of much of the low and moderate income housing that is going on at the current time.

We also have a major concern with regard to the retroactive aspect of the impact it would have on transactions already entered into and we feel that the legislation should be amended to exclude those contracts agreed to prior to this legislation.

Finally, we are aware that the Senate Finance Committee on the Oversight of the Internal Revenue Service is currently looking at and investigating issues related to the time value of money. We would suggest that this committee and the subcommittee on the Senate Finance Committee conduct a coordinated effort on these issues dealing with the cash and accrual method and the time value of money and come to an agreement on the new rules regarding this area.

Thank you very much for the opportunity to appear before you today, Mr. Chairman, and we will be happy to answer any questions that you might have.

Mr. FLIPPO. Thank you, Mr. Banks, for your testimony.

[The prepared statement follows:]

STATEMENT OF DOUG BANKS OF THE NATIONAL ASSOCIATION OF REALTORS

On behalf of the National Association of Realtors and its affiliate, the Real Estate Securities and Syndication Institute, we appreciate the opportunity to present our views on H.R. 699, The Condominium Cost Reduction Act, and H.R. 3592, the Minor Tax Equity Improvement Act.

The National Association of Realtors consists of nearly 600,000 members actively engaged in all facets of the real estate industry. The Real Estate Securities and Syndication Institute consists of approximately 3,500 members primarily involved in real estate syndications.

RECOMMENDATIONS

The National Association of Realtors supports enactment of H.R. 699, which would remove the current tax penalty which faces rental apartment building owners who directly convert the building to condominiums without the use of professional converter "middlemen." The legislation would improve tax equity by providing comparable tax treatment of gains from apartment building condominium conversions whether directly converted by the building owner or converted through the use of professional condominium converters. Current law may discourage condominium conversions which expands the supply of affordable housing.

The National Association of Realtors urges that, if enacted, H.R. 3692 be amended to provide the same related party rules for partnerships, Subchapter S corporations and corporations. We would suggest that this test require a 50 percent ownership interest. We also strongly recommend that the legislation be amended to apply only to deductible expenses arising from obligations created after enactment of this legislation.

H.R. 699—THE CONDOMINIUM COST RECLAMATION ACT

The past decade has seen a growing demand for condominium housing units. This type of ownership often provides the only affordable housing for the first time home owner and is ideal for elderly residents who desire security of ownership and who do not need or want larger, single family detached homes. However, the current tax structure inhibits an owner of rental property from dealing directly with existing tenants after the decision has been made to convert the property to condominium units because of the risk that any profit received on the sale of such units will be taxed to the owner as ordinary income. Under current law a taxpayer who has held rental property for investment purposes for a substantial period of time is normally taxed at capital gains rates upon the sale. The property would constitute depreciable property held in a trade or business and, therefore, would be accorded capital gains treatment under Section 1231(a) of the Internal Revenue Code in the event of its sale, subject to applicable depreciation recapture. However, if the taxpayer decides to convert the property to condominium units and sell them in multiple sales he runs a substantial risk that the entire gain will be taxed at ordinary income rates.

This result is based upon the theory that the taxpayer has become a "dealer" rather than an investor because of the conversion of the property to condominium units and the subsequent sales activity. In this situation all of the taxpayer's profit upon sale will be taxed as ordinary income. Congress attempted to deal with the analogous problem presented by the subdivision and sale of unimproved real property by enacting Section 1237 of the Internal Revenue Code of 1954.

Section 1237(a) provides that any lot or parcel that is part of a tract of real property in the hands of a taxpayer other than a corporation shall not be deemed to be held primarily for sale to customers in the ordinary course of trade or business at the time of sale solely because the taxpayer subdivided such tract for purposes of sale or because of any activity incident to such subdivision or sale if (1) such tract, or any lot or parcel thereof, had not previously been held by such taxpayer primarily for sale to customers in the ordinary course of trade or business and, in the same taxable year in which the sale occurs, such taxpayer does not so hold any other real property, (2) no substantial improvement that substantially enhances the value of the lot or parcel sold is made by the taxpayer on such tract while held by the taxpayer or is made pursuant to a contract of sale entered into between the taxpayer and the buyer, and (3) such lot or parcel, except in the case of real property acquired by inheritance or devise, is held by the taxpayer for a period of five years. This provision was enacted in an effort to specifically distinguish investors from dealers in real estate by allowing certain subdivision activities to be disregarded in determining whether a taxpayer is a dealer.

The Internal Revenue Service has held, however, that the benefits of Section 1237 do not apply to the conversion of rental units in an apartment building to condominiums and the subsequent sale of such condominiums to the public (Rev. Rul. 80-216). The Internal Revenue Service currently takes the position that "section 1237 of the Code will not apply where interests in realty are sold that do not include separate fee interests in the land that underlies the building. The Service, therefore, will not apply section 1237 to multi-story apartments." As a result, it is clear that under current law the activity of converting an apartment building to condominiums will ordinarily transform an investor in real property into a dealer and subject the full amount of the gain realized upon sale of the condominiums to taxation at ordinary income rates.

Because of this quirk in the tax laws, virtually all condominium conversions are accomplished with the involvement of converters. This involvement has the effect of causing upward pressure on prices, because the converter has to borrow short-term money to buy the building at high interest rates. For this same reason, converters have a strong incentive to sell the units as rapidly as possible so they can pay off the loan, resulting in pressure on tenants either to purchase the units or get out.

H.R. 699 would amend current law to provide comparable tax treatment, without regard to the use of a converter "middleman." The proposed amendment would result in capital gains taxation on appreciation, and ordinary income taxation on the gain beyond appreciation attributable to the conversion. This proposal should result in the Treasury receiving the same tax revenues from one taxpayer which it currently collects from two taxpayers. We understand the intent of this proposal to be to achieve a revenue neutral effect and to eliminate the purely tax motivated involvement of an outside converter.

In addition to providing greater equity in taxation, the National Association of Realtors supports H.R. 699 and the removal of the current penalty for direct owner condominium conversion because:

Condominium conversions are a direct response to the insatiable American desire to own a home: More than 65 percent of all Americans own their own home today, a 50 percent increase since the end of World War II.

Condominium conversions expand the supply of affordable housing: Our latest data show that, on average, apartment condominiums with a median price of approximately $54,800 were Americans' least expensive homes while single family detached homes were most expensive (a median price of $73,100).

Condominium homes fit today's household lifestyle and size patterns: Today, the one or two person household is the norm rather than the exception. Of the condominium buying households in 1981, 76.1 percent were comprised of one or two members while the same was true of only 50.2 percent of buyers of single family detached homes.

Condominium conversions have a significant positive fiscal effect on a community, especially on the local property tax base: Renovations and rehabilitations which often accompany the conversion process provide jobs for skilled tradesmen and business for suppliers of housing services and products. The total value of individual condominium units in a building is greater than its value as an apartment building—studies have found an increase in property tax ranging from 18 percent in Chicago to 34 percent in Boston.

H.R. 3592—THE MINOR TAX EQUITY IMPROVEMENT ACT

The National Association of Realtors and, in particular, the Real Estate Securities and Syndication Institute are concerned with that portion of H.R. 3592 which would amend the related party rules so that a payor would be placed on the cash-basis of accounting for the purpose of deducting business expenses and interest owed to a "related party" cash-basis taxpayer. Thus, a real estate partnership could not deduct unpaid amounts accrued to any cash-basis partner (or person/entity related under new rules to the partner) and any deduction for these amounts would be allowable only when paid.

The National Association of Realtors is concerned that enactment of the legislation as currently proposed will greatly discriminate against partnerships and Sub S corporations in favor of the corporate form of ownership. The proposal would apply a harsher ownership or control test for partnerships and Sub S corporations than is proposed for corporations. Specifically, Section 4(a) of the bill would require the denial of business expense deductions for transactions between a partnership and any person who owns any capital interest or profits interest of such partnership. For Sub S corporations, the new rules would apply to transactions between the Sub S corporation and any person who owns (directly or indirectly) two percent or more in value of the outstanding stock of such corporation.

The discrimination we are concerned with arises because the rules would apply only to corporate transactions involving related parties who control 50 percent or more of the corporation's outstanding stock. We recommend that a uniform control or ownership test be applied to partnerships, Sub S corporations and corporations.

Further, we are very concerned that the proposed legislation would apply to any expense incurred in any taxable year beginning in 1984 without regard to when the debt or other obligation giving rise to the expense was created.

Congress should be well aware of the reliance which taxpayers place in current tax laws. Almost universally, in the past when dealing with the tax law relating to debt instruments, Congress has made the effective date of tax changes the date of enactment, with no effect on existing contracts.

Partnership investment decisions are made with considerable reliance on the tax code. Investors who have anticipated returns based on current law are likely to suffer very adverse effects if the proposed legislation is, in effect, allowed retroactive application.

We recommend that H.R. 3592 be amended to exclude from its application any contract already in existence on the date this legislation is enacted.

Finally, we would agree with the Chairman's classification as "arbitrary" the present rule denying deductions for expenses paid to related parties later than two and one half months after the end of the taxable year.

We would suggest that instead of the approach taken under this bill, a coordinated effort be undertaken involving the Senate Subcommittee on Oversight of the Internal Revenue Service and this Subcommittee. The Senate Subcommittee is presently investigating similar issues relating to the time value of money and agreement on new rules might be better facilitated.

Mr. FLIPPO. I would like to ask any member of the panel to respond.

Do you believe that the determination of the fair market value prior to conversion presents any difficulties? Do you have any suggestions on that?

That seemed to be one of the concerns of Treasury.

Do you have any concern?

Mr. BANKS. Mr. Chairman, if I could comment on that. There are many areas of the Internal Revenue Code transactions that take place which require valuation.

This is not a new issue, and many times when there are purchases, you have to get valuation appraisals and allocate the same between various elements of the transaction. If you can do it that way, you ought to be able to do it in this situation.

Mr. DIENSTFREY. Mr. Chairman, it can be done. Valuations are under inheritances and in condemnations. But can you find a simpler way and meet the same general intent of trying to keep the bill revenue neutral?

If you stay with the appraisal method, first the owner might do an appraisal. The IRS might do a counter-appraisal. And then there will be an endless, needless hassle for basically not a great sum in the total revenue situation. Would a formula reach the same goal? With a formula everybody would know where they were without the negotiation and possible litigation that would be involved with an appraisal approach.

Mr. TAUBE. Mr. Chairman, I might say that in the real world determining a market value can be difficult, and two, three, four or five people can disagree.

I submit to you again that I think it is really unnecessary to even have to get to the point of discussing that issue. I have difficulty finding out why if I own an apartment building and I sell it to one person—let's assume I have owned it for 5 years or more, as your bill proposes—really what is the difference whether I sell the building to one person, a syndication or whoever or I sell it to 20 or 30 people? Selling price is the market value and we therefore remove the need for appraisals and all the things that Treasury is concerned about.

But again, even if there is a concern and even if we have to have, for whatever reason, some ordinary income treatment, I think that the appraisal formula is the most dangerous of all. It is really very, very easy to simply use our experience which tells us that the portion that should be subject to ordinary income—and we can reflect what is going on in the market—today would be somewhere in the 10 to 20 percent range.

So again, you don't even have to get into the issue of what is the market value of the building.

Mr. FLIPPO. Mr. Banks, your comments in regard to H.R. 3592, I believe your recommendation is to raise that percentage to 50 percent; is that what your recommendation was, from 20 to 50 percent?

Mr. **Banks**. That is currently what exists for corporations under those provisions. Our position is that there would be a discrimination against partnerships and subchapter S corporations.

Mr. **Flippo**. What impact do you feel that would have on the purpose of H.R. 3592?

Mr. **Banks**. Well, I guess it would have the same impact now that relates to corporations. There is already a provision that deals with the corporations, this provision is designed to eliminate possible abusive self-dealing where there is a degree of control. Without the change we propose, the section 267 rules would apply to partnership transactions regardless of control.

I think the main issue—and I think there is a great amount of discussion going on within Treasury and IRS and the joint committee about trying to decide accrual versus cash, the concern where one individual gets a deduction and somebody doesn't have to pick up income.

Mr. **Flippo**. If your recommendation were adopted, do you agree that it would pretty well eliminate the bill?

Mr. **Banks**. No. Although I really haven't evaluated how much impact the bill would have. I just think it should not be discriminatory against partnership transactions where there is not a degree of control.

Mr. **Beck**. Could I make a comment on that?

I am Ed Beck, the tax counsel for the association. I don't think that would have a major impact on the bill at all, because really what the bill is trying to do is prevent a mismatch of income and deductions, and it would involve situations where people have controlling interests before and after the transaction.

In this situation, if you had a 50 percent or less test, the person would not have a controlling interest. That is the whole theory behind the bill.

The 50-percent exemption would merely conform the bill, as was said, to the corporate situation and rationalize it. And I think that was the intent when it was drafted, anyway.

Mr. **Flippo**. Mr. Duncan?

Mr. **Duncan**. I have no particular questions other than to ask: Do most States have adequate laws now to protect people? Sometimes there are abuses in the condominium conversions. I know many States have written new laws on this.

Mr. **Taube**. There is the Uniform Condominium Act, which has been adopted in quite a number of States in a variety of forms. I think generally that the industry, whether it is the industry of owners, converters, tenants and so on, feel that the abuses that we were concerned about for a number of years have drastically been reduced. And I think that there is very clearly legislation in most States that protects the tenants and sort of sets up the rules of how the game is to be played. I think we are doing a good job of it.

Mr. **Duncan**. I would like to thank the panel. You have been very helpful with the information that you have supplied. It will be useful to us.

Thank you, Mr. Chairman.

Mr. **Beck**. I might just comment—42 States do have condominium conversion requirements.

Mr. **Duncan**. Thank you.

Mr. DIENSTFREY. Sir, in California we also have local legislation covering these issues.

Mr. FLIPPO. Thank you very much for your testimony.

Our next subject will be H.R. 2476, sponsored by the distinguished gentlemen: Mr. Duncan of Tennessee, Mr. Boner of Tennessee, and Mr. Skelton of Missouri.

We have a panel that will give us the benefit of their views: Mr. John S. Nolan, Mr. Richard D. Holton, and Mr. Harlan Dodson. If you gentlemen would come forward and make yourselves comfortable, we will be delighted to receive your testimony. And you might proceed as you agree among yourselves, or as you deem appropriate.

STATEMENT OF JOHN S. NOLAN, MILLER & CHEVALIER, CHARTERED, WASHINGTON, D.C.

Mr. NOLAN. Thank you, Mr. Chairman.

My name is John Nolan, and I speak today for a group of individual taxpayers from several States who have been unfairly subjected to unanticipated tax liabilities because of a recent Supreme Court tax decision. Prior to 1981, these individuals made so-called net gifts of property on the informed advice of capable tax counsel that no Federal income tax liability would result from such gifts. Gift tax liability was incurred and was paid, but the donors acted in most cases on the basis of a consistent line of U.S. Tax Court and Court of Appeals cases holding that no income tax liability would also arise from such net gifts.

Unfortunately, the Supreme Court decided to the contrary in 1982 in the *Diedrich* case and held that net gifts may, in fact, produce income to the donor. In doing so, the Supreme Court refused to limit its holding to those net gifts which occurred after its decision. The Supreme Court said that any change in the tax treatment of net gifts as the Court saw it was for this Congress to decide.

Now, regardless of the merits of the Supreme Court's decision, the result is not unduly burdensome as long as it is known to taxpayers in advance of their making net gifts. We strongly urge the enactment of H.R. 2476, which would protect taxpayers who made net gifts before the lower court decision in the *Diedrich* case. This was the first time taxpayers were on notice that they would incur income tax liabilities on such a net gift, and they should be protected from a retroactive application of the *Diedrich* decision. Thus, we do not ask that the transaction be made nontaxable. We are not seeking to reverse the *Diedrich* case; we ask only that the consequences of the Court's decision be made nonretroactive.

A net gift is a gift of property conditioned on the donee paying any gift taxes which are imposed on the transfer. For example, the retiring shareholder in a family business may wish to give stock in the business to his son or daughter, but he may not have sufficient liquid assets to pay the gift tax. The child may have other assets from which to pay the tax or be willing to borrow the money to pay the tax, if he or she is active in the business, and under those circumstances the retiring shareholder will make what we call a net gift.

Until the Supreme Court's decision in the *Diedrich* case, the income taxation of net gifts appeared well settled as a result of a long series of cases deciding the issue favorably to the taxpayer. The donor in these cases made a gift; he did not sell or exchange the gifted property. A gift is not ordinarily thought of as a sale or exchange which results in income tax consequences. The courts until 1981 agreed in a consistent line of cases in the Tax Court and in the U.S. Courts of Appeal for the Fourth, Fifth, and Sixth Circuits.

It was not until the Eighth Circuit decided the *Diedrich* case on March 4, 1981, that taxpayers and their tax counsel had reason to believe that income tax consequences would arise upon a net gift. The Supreme Court's decision in the *Diedrich* case has serious adverse consequences for taxpayers who relied in good faith on the earlier consistent line of cases holding that there was no income tax liability on a net gift transaction. As mentioned earlier, the result in *Diedrich* would be reasonable if the taxpayer were aware of it before he makes a net gift. In such an event, the taxpayer could have protected himself: one, by not making a net gift; two, by making a net gift of a smaller amount so as to have the assets available to pay the income tax; or three, by arranging to provide liquidity to pay the tax in some other way.

But because the *Diedrich* case was decided after so many net gifts had already been made, affected taxpayers will now be required to make unexpected, undesired and possibly imprudent dispositions of assets to pay unanticipated income tax, and to pay an income tax that they could have avoided had they had not been misled by a long line of authoritative cases. We submit that this is a unique set of facts where legislative relief is appropriate. H.R. 2476 avoids the inequitable results flowing from the Supreme Court's decision by applying the *Diedrich* rule prospectively only; that is, to net gifts made after the date the Eighth Circuit's decision put taxpayers on notice for the first time that such gifts may result in taxable gain.

The Treasury Department makes two points that deserve attention. They say that the Internal Revenue Service position on this issue has been clear since 1971 and that taxpayers were thus on notice that they might have an income tax liability on making a net gift. I respectfully suggest that the IRS position was instead quite equivocal on this issue until the mid- or late-1970s, but in any event, the IRS does not make the law. Only Congress and the courts make the law, and here the courts were consistently quite clear that there was no income tax liability on a net gift until the *Diedrich* decision. That included about a dozen Tax Court decisions on the issue and three separate U.S. Courts of Appeal decisions.

Second, the Treasury says that there will be a double benefit under the bill because the donor would avoid tax but the donee would get a basis step-up by reference to the gift tax paid. I would agree that such a result is not justified. The bill should be amended to provide that the donee will not get a basis step-up if the transaction is not taxable to the donor.

With that change, I strongly urge the enactment of H.R. 2476.

Mr. FLIPPO. Thank you, Mr. Nolan, for your outstanding testimony.

[The prepared statement follows:]

Statement of John S. Nolan

Mr. Chairman and members of the committee, my name is John S. Nolan. I am a member of the firm of Miller & Chevalier, Chartered, in Washington, D.C. I am appearing before you today on behalf of a group of individual taxpayers from several states who have been caught in a judicially-created trap. These individuals prior to 1981 made so-called "net gifts" of property with the understanding, based on the informed advice of their very capable tax counsel, that no federal income tax liability would result from such gifts. The Supreme Court decided to the contrary in 1982—holding that net gifts may in fact produce income to the donor. In doing so, the Supreme court expressly refused to limit its holding to those net gifts occurring after its decision, or after the 1981 decision of the United States Court of Appeals which it affirmed, notwithstanding the existence of a substantial body of case law which supported the opposite conclusion.

Although we believe the Supreme Court reached the wrong result in *Diedrich* (457 U.S. 191 (1982)), the result is not unduly burdensome so long as it is known to taxpayers in advance of their making net gifts. We strongly urge the enactment of H.R. 2476, which would protect taxpayers who made net gifts before the *Diedrich* decision was rendered from the harsh consequences of a retroactive application of that decision.

NATURE OF NET GIFTS

A net gift is simply a gift of property conditioned on the donee's paying any gift taxes that may be owed as a result of the transfer. The reasons for a net gift are that the donor is unwilling or unable to pay the gift tax whereas the donee is not. For example, the retiring shareholder in a family business may wish to give stock in the business to his son or daughter, but the retiring shareholder may lack sufficient liquid assets to pay the gift tax that would result. The child may have other assets from which to pay the tax or be willing to borrow the money to pay the tax if he or she is active in the business.

INCOME TAXATION OF NET GIFTS PRIOR TO *DIEDRICH*

Until the *Diedrich* decision, the income taxation of net gifts appeared well settled as a result of a number of cases deciding the issue favorably to the taxpayer.

The first case in which the Service argued that a net gift results in taxable income to the donor was a 1968 Tax Court case, *Turner* v. *Commissioner*, 49 T.C. 356 (1968), aff'd per curiam, 410 F. 2d 752 (6th Cir. 1969). In *Turner*, the court flatly rejected the Service's position that the donor realized gain to the extent the gift tax liability exceeded his adjusted basis in the gifted property. *Turner* was consistently followed in a series of decisions by the Tax Court and by the United States Courts of Appeals for the Fourth, Fifth and Sixth Circuits. E.g., *Krause* v. *Commissioner*, 56 T.C. 1242 (1971); *Hirst* v. *Commissioner*, 572 F. 2d 427 (4th Cir. 1978) (en banc), aff'g 63 T.C. 307 (1974); *Estate of Davis* v. *Commissioner*, 469 F. 2d 694 (5th Cir. 1972), aff'g per curiam 30 T.C.M. (CCH) 1363 (1971); *Owen* v. *Commissioner*, 652 F. 2d 1271 (6th Cir. 1981), aff'g 37 T.C.M. (CCH) 272 (1978) (case vacated September 11, 1981, and ordered held in abeyance pending disposition of *Diedrich* v. *Commissioner*, 643 F. 2d 499 (8th Cir.) cert. granted 454 U.S. 813 (1981). It was not until the Eighth Circuit's decision in *Diedrich* was rendered on March 4, 1981, that there was a single adverse decision on the income tax treatment of net gifts, as distinguished from cases where a pre-transfer debt against the gift property was effectively assumed by the donee (cf. *Johnson* v. *Commissioner*, 495 F. 2d 1079 (6th Cir.), cert. denied, 419 U.S. 1040 (1974). Accordingly, taxpayers and their tax counsel had no reason to believe that *Turner* was not the law in the net gift area.

HOLDING IN DIEDRICH AND ITS CONSEQUENCES

In *Diedrich*, the Supreme Court affirmed the Eighth Circuit, overruling 14 years of jurisprudence on the issue of net gifts. It held that a donor of a net gift realizes taxable income to the extent that the gift taxes paid by the donee exceed the donor's adjusted basis in the property. The Court reasoned that in effect, the donor has made a bargain sale of the property to the donee, the sale price being the amount necessary to discharge the gift tax indebtedness. The balance of the value of the transferred property, the Court ruled, is a gift. The gain realized by the donor is the amount of the gift tax liability assumed by the donee less the donor's adjusted basis in the property.

EQUITY OF A PROSPECTIVE APPLICATION OF DIEDRICH ANALYSIS UNDER H.R. 2476

The Supreme Court's decision in *Diedrich* may have serious adverse consequences for taxpayers who believed in good faith that the *Turner* case and the cases following it governed the federal income tax consequences of a net gift transaction. As mentioned earlier, the result in *Diedrich* can be tolerated so long as taxpayers are aware of it before they make a net gift. Had a taxpayer known that *Diedrich* would apply to a net gift to create taxable gain before making the gift, he could have protected himself by (i) not making a net gift, (ii) making a net gift of a smaller amount so as to have the assets to pay the income tax available, or (iii) arranging to provide liquidity to pay the tax in some other way.

Because the *Diedrich* rule was announced after many net gifts had already been made, affected taxpayers will now be required to make unexpected, undesired, and possibly imprudent dispositions of assets to pay the unanticipated income tax, and to pay an income tax that they could have avoided had they not been misled by a long line of authoritative cases. We submit that this is a unique set of facts where legislative relief is appropriate. H.R. 2476 avoids the inequitable results flowing from the Supreme Court's decision by applying the *Diedrich* rule prospectively only, that is, to net gifts made after the date the Eighth Circuit's decision put taxpayers on notice that such gifts may result in taxable gain.

PROBLEMS CAUSED BY RETROACTIVE APPLICATION OF DIEDRICH

The Supreme Court's constructive sale analysis in *Diedrich* has a number of anomalous related consequences which the Court ignored, and which taxpayers making and receiving net gifts in reliance on prior law could not have anticipated. These consequences also demonstrate that applying the *Diedrich* rationale to donors and donees involved in net gift transactions before that decision would be grossly unfair, particularly in light of the Service's concession in the *Turner* case that net gifts do not involve a constructive sale (see 49 T.C. at 357).

The first set of anomalous consequences of *Diedrich* relate to the donee's gain or loss on the subsequent sale of the net gift property. It is usually suggested that *Diedrich's* constructive sale analysis would invoke the bargain sale rules of Treas. Reg. § 1.1015-4. These rules would permit the donee a basis equal to the greater of (i) the donor's adjusted basis increased by the amount of gift tax attributable to the appreciation in the property at the time of the gift, or (ii) the gift tax paid. For example, assume a donor makes a net gift of property with a value of $1,000 and a basis of $100, and the donee pays a gift tax of $300. The donor's gain according to *Diedrich* would be $200. The donee's basis under the bargain sale rule would be $370, the donor's adjusted basis of $100 plus $270, the gift tax attributable to appreciation. However, if section 1012 is the applicable section to determine basis, the donee's basis is limited to $300, the gift tax liability paid. Section 1012 may well be applicable, because it applies by its terms unless a specific exception thereto is applicable, and no exception is specifically applicable to actual or constructive purchases and sales. If the donee's adjusted basis were limited to his actual cost of $300 under section 1012, $70 of basis would have disappeared.

The second set of anomalous consequences relates to the donee's holding period. It is probably the case that even though the donee acquires the net gift property in a transaction in which the donor's basis carries over in part, a new holding period begins (see I.R.C. § 1223(2); LR 7752001 (Aug. 25, 1977)); contra, *Citizen's National Bank of Waco* v. *United States,* 417 F.2d 675 (5th Cir. 1969)). This means that a sale by the donee before he meets the long-term capital gain holding period will create short-term captial gain.

Accordingly, it is clear that the *Diedrich* case does not merely restore taxpayers and the Government to their pre-gift status; it makes taxpayers affirmatively worse off for relying on a long time of contrary authorities. Furthermore, a retroactive application of *Diedrich* may result in serious administrative problems for both taxpayers and the Service because many donees who have sold net gift property may be required to amend their tax returns to take into account their higher adjusted basis or different holding period under *Diedrich.*

REVENUE EFFECT OF H.R. 2476

The proposed bill does not have the potential for significant reduction of income tax revenues. The only income tax that could be saved would be due to the shift in certain cases of the gain on the sale of the gift property from the higher capital gain tax bracket of a donor to the lower one of a donee. In the cases we are aware of, this shift is unlikely to involve significant revenues. Moreover, in at least on case we are aware of, the income tax result is more favorable to the taxpayer if the donor rather than the donee is taxed on the gain. To the best of our knowledge, no significant revenue gain or loss would result from the limited relief contained in the proposed legislation.

I will be pleased to answer any questions you may have.

Mr. FLIPPO. Mr. Holton?

STATEMENT OF RICHARD D. HOLTON, LECKRONE & HOLTON, NASHVILLE, TENN.

Mr. HOLTON. My name is Richard D. Holton, and I am an attorney and CPA. My law firm has been associated by Mr. William Waller of Waller, Lansden, Dortch & Davis to represent five of his clients who would be adversely, in my opinion, unjustly taxed and have a penalty placed on them if the *Diedrich* decision, which was decided in June of this year, is applied to transactions which took place by his clients more than 10 years ago.

My second interest stems from the fact that prior to the decision in *Johnson* in 1974, I advised more than 30 individuals, as a result of my being the head of a trust tax department of the largest bank trust department in the State of Tennessee—and advised these individuals in the making of a net gift. Now, at that time there was certainly a thought that there could be adverse income tax consequences to the donors from a net gift transaction, and those consequences stemmed from the application of the so-called grantor trust provisions of section 671 through 677 of the Internal Revenue Code. And so as a trust officer, I was brought in to advise how to properly structure the gift so as to avoid the implication of those rules.

But we were quite clear as to the law at that point in time, that while there could be adverse income tax application under the grantor trust provisions, no capital gains tax under a constructive sale theory would result.

The 30 individuals that I have worked with were involved in each case with independent competent counsel who were thought of as tax planning and estate planning specialists in Nashville, Tenn. In fact, I worked with every individual attorney in Tennessee who was really thought of as a tax planning specialist, with the exception of one individual who was not involved in any of the transactions.

Mr. Dodson was one attorney who I was involved with, and one of his clients, and he will tell you that at that point when his client made her gift there was no question as to the state of the law. The court law at that time was quite clear that there was no constructive sale, no capital gains tax. If each of the other attorneys—and there are approximately 10 of them who I worked with—were to come forth in front of this committee today, each of them would tell you that they also had that strong opinion—no capital gains taxes on this transaction. Certainly, income tax ramifications under the grantor trust provisions, but not capital gain tax.

The court in the sixth circuit in 1974 came out with a decision called the *Johnson* decision, and Judge Celebrezze, in that decision, through dictum, made a statement that in a case which was clearly different on its facts from the net gift situations, he made a statement which caused an evolutionary process to begin which really ended up in the *Diedrich* decision, which says that a constructive sale theory does apply in a net gift transaction. Even Judge Celebrezze, in his decision in *Owen* in 1981, in looking back at his previous decisions, has stated that it would be inappropriate for the taxpayers who relied on the line of cases that started in 1968—it would be inappropriate for those taxpayers who structured their transaction in reliance on the net gift theory to have to bear a burden of tax under the *Diedrich* type of holding.

There are quite a few other judges which I have mentioned in my written statement who made the same type of comment, even judges who feel that a net gift does give rise to a capital gains tax.

The Internal Revenue Service, in opposition to what they have said in their written statement, was totally inconsistent in their approach during this period. In 1957, they came out with a revenue ruling which stated that if a donor made a net gift transaction, here are the consequences to them. And they spoke only of the grantor trust rule.

In the commissioners 1968 brief in *Turner* he conceded that with regard to net gifts in as it relates to gifts of trust—that a capital gains tax would not result. Rather, the grantor trust provisions again were applicable. That is the exact time period that our donors were making these transactions.

So you had a consistent line of court cases saying no taxation under the constructive sales theory. The Service had conceded that issue, and now we are faced with this position here.

I think it would be an injustice to have the capital gains tax, to apply to pre-Diedrich transfers and I feel that this bill would adequately remedy it, with the one exception that I do agree with Mr. Nolan that there should not be a double step-up in basis to those donee's who received assets in a transfer to which this bill applies.

Mr. FLIPPO. Thank you, Mr. Holton.

[The prepared statement follows:]

STATEMENT OF RICHARD D. HOLTON

My name is Richard D. Holton, I am an attorney and a C.P.A. and I have two interests in the passage of this Bill. First, I have been associated by Mr. William Waller of the Nashville, Tennessee law firm of Waller, Lansden, Dortch and Davis to represent the interest of five of his firm's clients who would be adversely, and in my opinion, unjustly affected if the Supreme Court decision of *Diedrich* v. *Commissioner* decided on June 15, 1983 is applied to gifts made by these clients a decade ago.

My second interest in the passage of this Bill stems from my advising with more than thirty individuals who made net gifts prior to the Sixth Circuit Court of Appeals' decision in *Johnson* v. *Commissioner* on April 9, 1974. I advised those individuals to make the gifts because the law was well settled that no capital gains tax would be imposed upon a donor in a net gift transaction involving a gift into a trust. Certainly, adverse income tax effects could befall a donor under the "grantor trust" rules if the transaction was not properly structured, but not a capital gains tax under a constructive sale theory.

During the period prior to the decision in *Johnson* in 1974, I was a trust officer with Third National Bank in Nashville. Third National Bank's Trust Department was the largest in the State of Tennessee, and as the officer in charge of its Tax Department, I had the opportunity to advise with many of Nashville's prominent individuals concerning their estate planning needs. It was especially essential that a trust officer be involved because of the intricacies of structuring a net gift so as to avoid the pitfalls of the grantor trust provisions.

In each instance, the donors I advised with were represented by counsel who were tax and estate planning specialists (e.g. I advised with Mr. Waller on three of the five clients whose interest I am representing today before this Subcommittee). During the course of the three-year period prior to the *Johnson* decision, I had the opportunity to work with nearly every prominent attorney in Nashville who was considered a tax and estate planning specialist. Each of these attorneys advised his clients to enter into a net gift transaction based upon his firm belief that the consequences to the donor/grantor was covered by the grantor trust provisions and that no adverse capital gains tax consequences would arise under a constructive sale theory. I worked with Harlan Dodson, Esq., who is also a witness before this Subcommittee, regarding a net gift made by one of his clients and I can assure you that he will testify as to the strength of his conviction that the law on this point was well-settled—no capital gains would result from a net gift transaction! I am equally sure that each of the other attorneys who advised with the grantors with whom I worked, if called to testify here today, would state the same opinion as Mr. Dodson with equal conviction.

Sound business and estate planning requires that taxpayers be allowed, even encouraged, to rely upon the opinion of competent counsel. To apply *Diedrich* on a retroactive basis would be an unjust penalty to those I represent here today and whom I advised with because in each instance that reliance was present.

I would like next to elaborate on the sound basis that each of these attorneys had for believing that the state of the law was well settled on this point when their advice was given. To this end, the following chronological sequence of events is presented.

1957

Event: Commissioner publishes Rev. Rul. 57-564, 1957-2 C.B. 328.

Fact pattern: Donor transferred stock to a trust for the benefit of a relative. The Trustee, by prior agreement, obligated itself to pay the donor's gift tax with funds borrowed from a bank using the stock as collateral. The loan was to be repaid by dividends on the stock.

Holding: The Commissioner reponded that "with respect to the income tax consequences to a donor, pursuant to a trust instrument, requiring the donee trust to pay the federal gift tax on the gift of such stock." . . . that "income of the trust which is applied by the Trustee in satisfying the obligation incurred to pay the gift tax of the donor, is taxable to the donor under the provisions of Section 677 of the Code."

Comment: The Commissioner did not suggest any other income tax consequences to the donor. The clear implication being that there were none if such a gift was made into a trust.

1962-1963

Event: Decision in *Estate of Morgan*, 37 T.C. 981 (1962) affirmed per cur., 316 F.2d 328 (CA-6, 1963), cert. denied.

Fact pattern: Same as Rev. 57-564, except that the gift taxes could be paid by sale of stock or by borrowing funds. Further, if funds were borrowed, the Trustee could repay indebtedness with any funds in its possession.

Holding: The donor was held not to be taxable on trust income under Section 677 which was earned after the gift tax was paid. The Court held that the benefit, if any, to the doctor was purely illusory.

Comment: The holding of Rev. Rul. 57-564 was not followed and the factual pattern in this case was used on most net gift transactions that followed so as to avoid adverse affects under the grantor trust provisions.

1968-1969

Event: Decision in *Turner*, 49 T.C. 356 (1968), aff'd per cur., 410 F.2d 752 (CA-6, 1969).

Fact pattern: Gift into a trust the same as in *Morgan* in addition net gifts were made to individual donees.

Holding: No constructive sale in either instance but rather a net gift with no capital gains tax to the donor.

Comment: The Commissioner did not even raise the constructive sale issue with regard to the transfers in trust. In fact, in his brief he conceded that the transfers in trusts were not sales.

NOTE.—The Commissioner issued a belated non-acquiescence to *Turner* in 1971. However, since he had not argued a constructive sale theory, this action has no effect on gifts into a trust. Futhermore, all the gifts I was called to advise upon involved gifts into trusts.

1971

Event: Decision in *V. W. Krause,* 56 T.C. 1242 (1971).
Fact pattern: Virtually identical to *Turner.* Trustee paid taxes by borrowing on corpus and repaying loan over six-year period.
Holding: The donor was not taxable on income under Section 677 (Rev. Rul. 57-564 not applicable). Donor was not taxable under a liquidation of income interest approach, nor was the constructive sale theory deemed applicable.
Comment: The Commissioner tried all his guns in this case and lost on all three theories.
Note.—In 1972, the appeal to the Sixth Circuit was dismissed nolle pros by the Commissioner. Thus, the constructive sale theory apparently was laid to rest.

1972

Note.—The Tax Court decision holding against application of the constructive sale theory in *Estate of Davis,* 30 T.C.M. 136, was affirmed per curiam by the Fifth Circuit Court of Appeals at 469 F.2d 694.

1974

Event: Sixth Circuit Court of Appeals affirming the Tax Court's decision in *Joseph W. Johnson, Jr.,* 495 F.2d 1079.
Fact pattern: Donor borrowed $200,000 from a bank "without personal liability" using securities as collateral, then transferred his ownership in the pledged securities to a trust for his children. The Trustee replaced the donor's note with their own note secured by the same collateral. The $200,000 was used by donor for his own purposes including the payment of $150,000 in gift taxes.
Holding: The Sixth Court affirmed the Tax Court's holding that the gift was in effect a part/gift and part/sale but Judge Celebrezze, who wrote the Court's opinion, stated in dictum, that *Turner* had "no precedential value beyond its peculiar fact situation."
Comment: This transaction was not structured as a net gift and there were at least two previous cases holding that in such situations a constructive sale theory would apply.
Note.—The activity of the audit section of the Internal Revenue Service in the Nashville district in assessing deficiencies based upon the constructive sale theory substantially increased after the *Johnson* decision in the Court of Appeals.

It is my opinion that each of the attorneys involved in net gift transactions prior to the Sixth Circuit's *Johnson* opinion was entirely correct in placing strict reliance on *Turner* in gifts ot individual donees, and also placing strict reliance on the entire series of events outlined above regarding gifts to trusts, and accordingly, in advising his clients that the constructive sale theory did not apply to net gifts. I am of the further opinion that it would be grossly unjust to penalize clients for relying on the sound advice of competent counsel by applying a constructive sale theory to impose a capital gains tax to the donor of a net gift transaction. It is interesting to note that even Judge Celebrezze who began the evolutionary process culminating in *Diedrich,* through his dictum in *Johnson* believed it would be inappropriate to apply the constructive sales doctrine to pre-*Johnson* transfers. In his opinion for the Sixth Circuit Court of Appeals in *Owen* v. *Commission,* 652 F.2d 271 (1981), *Judge* Celebrezze said: "As a practical matter, the analysis in *Johnson* left only a narrow area in which *Turner* could have any further precedential value. Had the present transactions occurred after *Johnson* was decided, any taxpayer reliance on *Turner* might well be misplaced. See *Comm'r.* v. *Estate of Church,* 335 U.S. 632, 646-51 (1949). But the transfers here were consumated on Jan. 2, 1973; *Johnson* did not become the law in this circuit until April 9, 1974. Taxpayers assert that they modeled their transactions on *Turner,* and at that time had no reason to doubt *Turner's* viability, especially in light of the Commissioner's decision to seek dismissal of the appeal in *Krause, supra.* This argument has the clear ring of common sense to it. We view this as a situation of significant reliance on *Turner,* a reliance sufficiently valid to be vindicated by *stare decisis.* For *stare decisis* "requires that people in their everyday affairs be able to rely on our decisions and not be needlessly penalized for such reliance." *United States* v. *Mason,* 412 U.S. 391, 399-400 (1973). Cf. *Helvering* v. *Hallock,* 309 U.S. 106, 119 (1940).

Many other judges have also made comments regarding the propriety of attorneys and the courts relying on the unblemished history of the court's uniformly not agreeing to apply a constructive sale theory to net gifts.

Judge Raum in *Hirst* v. *Comm'r.,* 63 T.C. 307 (December 1974): "Things have gone too far by now to wipe the slate clean and start all over again."

Judge Featherstone in *Estate of Henry,* 69T.C. 665 (Feb. 1978) Despite this overwhelming precedent to the contrary, respondent (Commissioner) continues to urge that we change our long-established position on this issue in order to sustain a tax deficiency . . . against a taxpayer who justifiably relied upon that clear precedent in making the gifts which are the subject of this case. . . . In these circumstances, under the principle of stare decisis and fair play with a taxpayer who has relied upon our prior opinions, which opinions have been affirmed by higher courts or in respect of which appeals have been dismissed, we must follow the *Turner* case and hold that petitioner did not realize taxable income as a result of the conditional transfers here in dispute.

Judge Kennedy in her concurring opinion in *Owen* v. *Commissioner,* 652 F.2d 1271 (6th Cir., June 1981) "I am not persuaded, however, that *Turner* was wrongly decided or that the holdings in *Turner* and *Johnson* are inconsistent. *Turner,* as pointed out by Judge Celebrezze, has been widely followed. It has undoubtedly been relied upon. If its holding is to be changed that change should be made by the Congress."

Judge Edwards, even in his dissenting opinion in *Owen* v. *Commissioner,* 652 F.2d 1271 (6th Cir., June 1981) stated that: "But if the fact that this case arose in between *Turner* and *Johnson* and in probable reliance on *Turner* is of sufficient significance to my colleagues to be a determinative factor, I would propose that we overrule the *Turner* case prospectively and continue that policy in relation to any similar cases in this Circuit where the facts clearly indicate reliance upon *Turner* prior to our *Johnson* decision."

WRITTEN SUPPLEMENT TO STATEMENT OF RICHARD D. HOLTON

The statement on behalf of the Treasury relating to H.R. 2476 is misleading by stating that "at least as far back as 1971" (i.e. prior to the decision in *Johnson* v. *Commissioner,* 495 F.2d, 1079 (6th Cir. 1974) the I.R.S. was taking the published position that the donor of a net gift can realize a capital gain from the gift, and in stating that "taxpayers were on notice that the failure to report on a net gift would likely be opposed on audit." The Treasury bases these statements on the fact that they published a Revenue Ruling in 1971 putting donors on notice of their position. The Ruling referred to is Revenue Ruling 71-232, 1971-1 C.B. 275. This Ruling explains the method of valuation of a net gift for *gift tax purposes.* The I.R.S. would not have used a gift tax ruling as a means of publishing a position on an income tax question nor would a taxpayer look to a gift tax ruling for income tax consequences. In fact, the Ruling itself states that the Revenue Ruling was concerned only with the gift tax and not the income tax consequences resulting from a net gift transaction.

It is almost unimaginable to me that the Treasury's statement could be to the effect that their published position was consistent and in doing so relied on the beforementioned gift tax Revenue Ruling when the following three events also happened during the period prior to *Johnson.* First, the Treasury had a Revenue Ruling dealing exclusively with the income tax consequences to a donor in a net gift transaction. Rev. Rul. 57-564, 1957-2 C.B. 328. (I am enclosing a copy of the Ruling as Exhibit A for your own observation.) Second, the Commissioner in *Turner* conceded in his brief that net gift transfers to trusts were not to be treated as a part gift/part sale. The following statement was made by the Sixth Circuit Court of Appeals in the *Turner* case regarding the Commissioner's concession: "In the Tax Court, the Commissioner of the Internal Revenue Service conceded that the amounts paid by the Trustee to the donors were not taxable to her for the reason that the Trustees did not personally agree to make the payments, but agreed only to reimburse her for the gift tax of the income derived from the transferred shares. The Commissioner makes the same concession in this Court, although for different reasons."

Third, the decision of the Commissioner to dismiss his appeal of the Tax Court's decision in *V.W. Krause,* 56 T.C. 1242 (1971) holding that a net gift transfer did not give rise to capital gains.

I feel Treasury's continued insistence that their position was consistent on the income taxation of net gift transaction in spite of their own published actions to the contrary is indicative of why it would be unjust to impose a tax on individuals who relied on a consistent body of case law holding to the opposite effect.

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Rev. Rul. 57-564

Where a sole stockholder transferred all stock of a corporation to a trust for the benefit of his nephew upon the condition that the trustees promptly pay the gift taxes on such transfer with funds to be borrowed by the trust from a bank on security of the donated stock, the income of the trust which is applied by the trustees in satisfying the obligation incurred to pay the gift taxes of the donor is taxable to the donor within the purview of section 677 of the Internal Revenue Code of 1954.

Advice has been requested with respect to the Federal income tax consequences to a donor, pursuant to a trust instrument, requiring the donee trust to pay the Federal gift tax on the gift of such stock.

An individual owned all of the stock of a corporation. He made a gift of such stock in trust for the benefit of his nephew, who is an executive vice-president and treasurer of the corporation. The purpose of the transfer was the orderly transmission of the business to the nephew during the donor's lifetime. The trust initially had no assets other than the stock of the corporation.

In connection with the trust, the instrument provides that the gift of all of the stock of the corporation to the trust is made upon the express condition that the trustees assume and agree to pay any Federal gift tax which may be incurred as a result of such gift. The trustees further agree that the trust will promptly pay such taxes with funds to be borrowed by the trust from a bank on security of the donated stock.

Section 677 of the Internal Revenue Code of 1954 provides, in effect, that the grantor of a trust is taxable on income directed to his benefit or to discharge his legal or contractual obligations. Section 2502(d) of the Code provides that the tax imposed by section 2501 on the transfer of property by gift shall be paid by the donor.

In the case of the *Estate of A. E. Staley, Jr.* v. *Commissioner*, 136 Fed. (2d) 368, certiorari denied, 320 U. S. 786, the decedent desired to make gifts of stock to his five children but did not have sufficient funds to pay the estimated gift taxes payable on the contemplated gifts. In order to obtain such funds and still place the stock in trust, he transferred the stocks in trust in consideration of the trustee's payment to him of 30,000 dollars from the income of each of the trusts, an aggregate of 150,000 dollars. The court stated that it is elementary that artificial language in an instrument of conveyance does not suffice to alter the tax significance of the substance of the transaction. Whether the transactions were regarded as gifts of all the corpus and all the income in excess of 150,000 dollars, or whether they were deemed to be gifts in trust with a reservation to the donor of a specified amount of income, was immaterial. The substance is the same, and in either event the entire amount was income to the donor.

In the instant case, the trust is to borrow, with the stock as security, funds sufficient to pay the gift tax. The indebtedness is then to be satisfied from the income of the trust. The liability for the tax is a liability of the donor. Accordingly, the Internal Revenue Service holds that income of the trust, which is applied by the trustees in satisfying the obligation incurred to pay gift tax of the donor, is taxable to the donor under the provisions of section 677 of the Code. See Rev. Rul. 54-516, C. B. 1954-2, 54.

Mr. FLIPPO. Mr. Dodson.

STATEMENT OF HARLAN DODSON, DODSON, HARRIS, ROBINSON & ADEN, NASHVILLE, TENN.

Mr. DODSON. Mr. Chairman and members of the committee, my name is Harlan Dodson. I have been a practicing attorney in Nashville, Tenn., for now in excess of 44 years except for 3-plus years in the Army of the United States in World War II.

First I want to express my sincere appreciation to my friend of many, many years, Representative John Duncan, for introducing this bill, and to the Congressman from my own district in middle Tennessee, Congressman Boner, who joins with him. I do not know the other Congressman who is from Missouri, one of our neighboring States.

I want to also express my appreciation to this committee for permitting us to appear here.

I represent an 87-year-old widow. That is the only one I am going to talk about, not the theory of the law but the pragmatic effect of the lack of passage of 2476. I have represented this lady for some 30 years.

Back in 1971, after her husband died, she found herself in the enviable position of not needing all of her income. In fact, she did not need the income from her personal estate because she was the life beneficiary of a substantial trust that had been created by her father. She was a widow. It was more than enough to satisfy her needs, but she had eight grandchildren.

So after talking with her tax advisors, including Mr. Holton over at the bank, she came to me as her attorney and I recommended to her that she create a trust for each one of these grandchildren. I was a grandfather myself. That would permit her during her lifetime to see them enjoy the income.

But before recommending that, I did what any country lawyer would do; I went to the books. And when I went to the books, lo and behold, I found that in *Morgan,* which had been decided in 1961 by the tax court and affirmed by the sixth circuit court and by the Supreme Court of the United States, that we could do this.

I found that in *Turner,* which was decided in 1968, that the sixth circuit court had said we could do this and that the Government on brief, on appeal from the Tax Court in that case had conceded that if it was going to a trust, you could do it. It would not be a constructive sale.

And then I found very recently a 1971 opinion in *Krause,* which had been decided then by the Tax Court, that court of specialists that the Congress had created to deal with these complicated tax issues, and I lifted the language in her trust fresh out of *Krause.*

When *Krause* was appealed by the government to the sixth circuit, they did not even carry forward the appeal but rather dismissed it because they recognized, I respectfully submit, that that was the law.

It was not until March 4, 1981, that the rug was pulled out from under us. We had had 20 years of case law and at the time I advised her, I had all of the case law in my favor or in her favor.

The situation then was that unless this bill is passed, the disastrous and inequitable result that she will find herself in, Mrs. Henry, will be that she relied upon the law that was in existence at the time she acted. She is to be penalized because her lawyer thought that he could depend upon the law as decided by the courts, all of the law decided by all of the courts at that time in the field of taxation and in this particular field.

We respectfully submit that this bill cries for passage to take care of these gross inequities that have resulted because lawyers went to the books.

Thank you very much.

Mr. **Flippo**. Thank you, Mr. Dodson, for your testimony. It is easy to see that your client made a good decision in selecting you for her counsel.

[The prepared statement follows:]

STATEMENT OF HARLAN DODSON, DODSON, HARRIS, ROBINSON & ADEN, NASHVILLE, TENN.

My name is Harlan Dodson. I am an attorney engaged in practice in Nashville, Tennessee, where I have been so engaged since September, 1939, excepting for some three years' service in the Army of the United States. My office address is 900 Nashville City Bank Building, P.O. Box 2524, Nashville, Tennessee, 37219 and my office telephone number is (615) 244-6840. My residence is 2 Redbud Drive, Nashville, Tennessee, 37215 and my home telephone number is (615) 383-4866. A substantial portion of my practice has been dedicated to estate planning and administration of estates, and I am a Fellow of the American College of Probate Counsel and lectured in these fields at the YMCA Law School located in Nashville, Tennessee, for some 20 years.

My clients are Estate of Douglas Henry, deceased, Third National Bank in Nashville, Kathryn C. Henry, Co-Executors and Kathryn C. Henry, surviving wife, individually. The gifts which involve my clients are gifts made by Kathryn C. Henry to eight (8) trusts for her eight (8) grandchildren on December 22, 1971. These gifts were "net gifts", that is the Trustee was to pay any gift tax out of the corpus of the trusts. The purpose of my appearance is in support of H.R. 2476 which would provide that no gain would be recognized for purposes of the Internal Revenue Code of 1954 from any net gift made before March 4, 1981.

The Tax Court of the United States found as a fact, based upon undisputed testimony, that Mrs. Kathryn C. Henry, a Tennessee resident, and her attorney relied upon the Tax Court cases of *Krause* v. *Commissioner,* 56 T.C. 1242 (1971), *Turner* v. *Commissioner,* 49 T.C. 356 (1968), 410 F.2d 756 (Sixth Cir., 1969), and *Estate of Morgan* v. *Commissioner,* 37 T.C. 981 (1962), aff'd. 316 F.2d 238 (Sixth Cir., 1963), *cert. denied,* 375 U.S. 825 (1963). This, therefore, is an established fact.

Tennessee, the residence of Mrs. Henry, is under the jurisdiction of ther United States Court of Appeals for the Sixth Circuit which encompasses the states of Michigan, Ohio, Kentucky and Tennessee.

Mrs. Henry was the life beneficiary of a trust created by her father and the income from it was sufficient to meet her needs. Accordingly, Mrs. Henry did not need the income from the stocks which constituted the corpus of her gifts to the eight (8) trusts out of her own personal estate. The effect of H.R. 2476 under the factual situation in Mrs. Henry's gifts would avoid a grossly inequitable result since at the time she made her gifts there was no case law on net gifts contrary to the *Krause, Turner* and *Morgan* cases above referred to. The Commissioner apparently recognized the rule of law as set out in the *Turner* case as being the applicable law since the Commissioner dismissed his appeal of *Krause* before hearing in the United States Court of Appeals for the Sixth Circuit to which he had appealed.

Since the *Turner* case, the Tax Court has consistently applied the *Turner* rule in all net gift cases coming before it and such cases as were appealed to the United States Court of Appeals for the Fifth Circuit and the Fourth Circuit were likewise affirmed as to the treatment of net gifts. The first Circuit to reverse the several opinions of the Tax Court was the United States Court of Appeals for the Eighth Circuit in the case of *Victor P. Diedrich, et al* v. *Commissioner,* which Opinion was filed on March 4, 1981 and which reversed the Tax Court of the United States which in turn had followed the established net gift rule. The decision of the Eight Circuit in the *Diedrich* case was affirmed by the Supreme Court of the United States.

It is respectfully submitted that taxpayers and their attorneys are entitled to rely upon the law as established by the final opinion of the Courts at the time they act. This was certainly the situation in 1971 when Mrs. Henry made her gifts relying upon all of the decisional law including the decisional law in the Circuit in which she resided. We respectfully pose the question, if Mrs. Henry and her attorney were not justified in relying on the law as interpreted by the Courts and especially the United States Court of Appeals for the Sixth Circuit, as well as the two opinions of the Tax Court, which was all of the decisional law existing at the time she made her gifts on December 22, 1971, then any act taken by a taxpayer is taken at their own risk.

As can be seen from the foregoing recital unless they can so rely, a gross inequity occurs. H.R. 2476 would remove this inequity as respects any such net gifts before March 4, 1981, the first time any Court had held contrary to the decisional law in effect some 10 years earlier, when Mrs. Henry made her gifts.

There are only a few cases to which H.R. 2476 would apply, and compared to the income taxes regularly being collected the result of H.R. 2476 would be infinitesimal. The horrible inequity of the decision in *Diedrich*, if applicable to Mrs. Henry's case, would be remedied by H.R. 2476 and we submit that the same should be recommended for passage.

Mr. FLIPPO. Mr. Duncan.

Mr. DUNCAN. Thank you, Mr. Chairman.

I want to welcome all three of you gentlemen to the committee, especially my friend of several years, Harlan Dodson.

I agree with the chairman that anyone that selects Mr. Dodson to represent them makes a wise selection.

Mr. DODSON. Thank you, Mr. Duncan.

Mr. DUNCAN. Let me ask you a question. Are there very many cases where 2476 would apply?

Mr. DODSON. Comparatively, there are few cases, Mr. Duncan. When you are talking about the total amount of revenue, income tax revenue in the billions of dollars, we are talking about, an infinitesimal amount here, really we are talking about in each instance a change in bracket rather than a change in no tax.

Mr. DUNCAN. Well, you have certainly made a good case for equity in this situation. You relied upon the law.

Would you care, Mr. Holton or Mr. Nolan, to amplify your statements on what specific inequities you believe exist in the cases that you are talking about?

Mr. HOLTON. The specific inequities really stem from the fact that a taxpayer had a rational basis to believe that their attorney could read the law so that they could make and plan a transaction based upon the law at that time.

Now, it took some 25 years before the Supreme Court addressed the net gift issue. The Supreme Court had three times to grant certiorari, three opportunities, and they decided not to. It is not appropriate for a person to wait until a Supreme Court decision comes down before they can say what the law is, in that 25-year time period many of them would have died without doing anything.

In fact, three of the people that I worked with are dead at this point in time. They made transactions based upon estate planning needs then, and it would be inequitable to come along 10 years later and say that was not the law then, when it was very clear that the state of the law was that there was no capital gains tax on net gift transactions.

Mr. **Duncan**. Do all three of you agree that there is no great revenue loss in applying this *Diedrich* decision prospectively?

Mr. **Nolan**. We do not think there would be any substantial revenue loss, Mr. Duncan. We have been in touch with the people around the country who might be interested in it. There are a very limited number of people who are interested. In each case that we have dealt with, there has been the kind of inequity that Mr. Dodson has illustrated here.

The change that I have suggested in the bill would insure that there is no substantial revenue loss because, in effect, there would be a carryover basis of the donor's basis to the donees so that when the donee subsequently disposes of the property, the gain would be recognized to the donee.

So we are only talking about the possibility of a difference in tax attributable to a different tax bracket that the donee might be in versus the donor, plus the delay in payment of the tax from the time that the gift was made.

Now, when you take all those factors into account, given the limited number of cases that exist out there, I think that the revenue loss from this bill is insignificant.

Mr. **Holton**. I would also make one other point on that. The Treasury states that the beneficiaries and the donor get a benefit under the *Diedrich* type of holding from the standpoint that you are allowed to aggregate your basis.

Well, as a practical matter, with regard to type of individual who was involved in a net gift transaction, let's say the six individuals that Mr. Dodson and I represent, I personally know that in those cases, not much of a benefit was realized. For example, in the *Owen* case, that transaction involved almost a zero basis in each share of stock transferred. So if you aggregate a bunch of zeros, you still get zero.

In Mr. Dodson's case, while it was a large amount of gift taxes paid, $2 million in gift taxes paid, if you aggregated your basis, you probably would not come up with $100,000. So the aggregation of basis that Treasury feels is a benefit to the people in the type of transactions that are involved, it just is not significant at all.

Mr. **Duncan**. Has this matter been considered in the Senate?

Mr. **Holton**. Not to our knowledge.

Mr. **Dodson**. Senator Sasser has introduced an identical bill, but it has not been considered, Mr. Duncan.

Mr. **Duncan**. Thank you very much, Mr. Chairman.

Mr. **Flippo**. Mr. Schulze.

Mr. **Schulze**. I have no questions. Thank you, Mr. Chairman.

Mr. **Flippo**. Thank you very much for your testimony.

Mr. **Nolan**. Thank you, Mr. Flippo.

Mr. **Flippo**. Our next subject for hearing today is H.R. 2504, introduced by Mr. Schulze and Mr. Murtha. And to testify we have a distinguished former member of this committee, Hon. Don Bailey of Pennsylvania.

Don, it is a pleasure to have you before the committee. We will be pleased to receive your testimony on this important piece of legislation.

STATEMENT OF HON. DON BAILEY, FORMER REPRESENTATIVE FROM THE STATE OF PENNSYLVANIA

Mr. **Bailey**. I thank you, Mr. Chairman. I remain, as always, a great admirer of yours. However, that seat that you took over there, I must confess I wish were mine still.

I very much enjoy the opportunity to be back before the committee. The matter I am testifying on is very, very close to my heart personally and it is something that, much more importantly, is very important to Pennsylvania and to a great university in particular.

It is an issue concerning a change in procedure, that IRS had affected a longstanding tradition of recognizing the ability and right of Pennsylvania State University to be able to issue tax exempt bonds which they used to finance lapses in State funding and to help finance some building at the university and that sort of thing.

The revenue loss is absolutely minimal. It is only a matter of making sure that they do what they have done for 20 some years, a change in policy which, incidentally, Mr. Chairman, has been effected without any change in law or regulation.

Mr. Schuckers, who does an excellent job in representing the university, has entered a statement in the record.

[The prepared statement of Mr. Schuckers follows:]

Statement of David R. Schuckers, Director, Government Relations, Pennsylvania State University

Over the years, the Pennsylvania State University has been required to borrow operating funds from Pennsylvania banks whenever the State legislature has been delayed in providing the annual Penn State appropriation. In addition, some self-amortizing capital construction projects, most notably residence hall projects, have been financed by the issuance by Penn State of long-term bonds.

Historically, the Internal Revenue Service has regarded the debt obligations of this land-grant university to be governed by section 103 of the Internal Revenue Code which, for Federal income tax purposes, excludes from the gross income of a lender the interest earned on a debt obligation issued by a State or a political subdivision of a State.

This has enabled Penn State to borrow at the lower tax exempt rate, rather than at the taxable rate. The ability of the university to borrow money at the tax-free interest rate has enabled it to save substantial interest expense. Since 1957, the university has issued approximately $85 million of long-term tax-free bonds to construct residence halls and food service operations. Equally significant, the university has been able to borrow as much as $50 million of short-term funds at the tax-free rate from banks to meet current operating expenses whenever the State appropriation has been delayed.

Recently, the Internal Revenue Service reversed its historical position and decided that the interest earned on Penn State debt is subject to Federal income tax. This decision was made by the Internal Revenue Service despite the fact that there has been no change in the applicable law and regulations. If the decision stands, Penn State will be required to pay interest at the taxable rate, which will substantially increase operating costs, particularly in this time of high interest rates.

We hope that commonsense will prevail over highly technical interpretations of regulations which exclude this land-grant university from economic advantages it historically has enjoyed, advantages held by our sister land-grant schools.

The purpose of H.R. 2504 is to affect a status quo ante. It would not do more and if it did less, a great university would be singled out for less than fair treatment. Penn State would be at a marked disadvantage as compared to other institutions across the country.

We ask only that our former status be restored with corrective legislation.

Mr. **Bailey**. The bill is introduced by a former colleague of mine, Mr. Schulze of Pennsylvania, and Mr. Murtha.

There is not too much I can say; this is just a little piece of justice we would like to see get done. It is not an issue of abuse here or of taking advantage nor does it involve a lot of money. It is just a matter of what is fair.

Thank you.

Mr. **Flippo**. Thank you, Don, for your testimony.

Mr. **Duncan**. Thank you, Don, for being back with us.

I have no questions.

Mr. **Bailey**. Thank you.

Mr. **Flippo**. I am glad you are doing so well and prosperous, and looking so happy.

Mr. **Schulze**. Mr. Chairman, I, too, would like to welcome my former colleague.

I would also like to ask unanimous consent that a statement by Congressman Murtha be put at the conclusion of the testimony by Mr. Bailey.

Mr. **Flippo**. Without objection.

Mr. **Schulze**. I have to concur with your testimony, Don. Not only is this a matter of equity, but the university had been led through previous revenue rulings to depend upon this type of treatment, isn't that true?

Mr. **Bailey**. Yes, it is.

Mr. **Schulze**. We both know the vagaries of the Pennsylvania State Legislature. If it was not a group of human beings, this might not be necessary.

This privilege or power has not been abused in the past and I do not think it will be in the future, but it does in the long run accrue to the benefit of the taxpayers, in my opinion, in the Commonwealth of Pennsylvania as well as those employed by the Pennsylvania State University and those who are the beneficiaries of that educational institution.

I appreciate your efforts on behalf of Penn State and I know that this will lead to the recruitment of a person who can lead us to victory.

I thank you, Mr. Chairman. Thank you.

Mr. **Flippo**. Without objection, we will also include any statement that Mr. Schuckers might wish to insert in the record as well.

Mr. **Bailey**. Thank you.

[The prepared statement of Mr. Murtha follows:]

STATEMENT OF HON. JOHN P. MURTHA, A REPRESENTATIVE IN CONGRESS FROM THE STATE OF PENNSYLVANIA

Chairman Stark and committee members, I am proud to be a co-sponsor of Congressman Schulze's bill involving tax treatment of land grant universities.

I can see no justification for the Internal Revenue Service altering the tax status of The Pennsylvania State University. To any logical assessment of the facts, there can be no doubt that Penn State has clearly been designated under the land-grant act and has functioned in that capacity for Pennsylvania.

The end result of the I.R.S. action is very plain. It will not greatly benefit the Federal Government, and Penn State will continue its educational process. The people who will be hurt are the students and their families associated with Penn State. For if the cost of education rises, it will fall squarely on the students. In fulfilling its land-grant status, Penn State remains a key for providing a cost effective education for the sons and daughters of the working people of the Commonwealth of Pennsylvania. If these costs of borrowing money connected with this bill are passed along at the same time of fiscal tightness at the Federal and State levels, the only logical conclusion is that there will be further pressure for a rise in tuition of other educational costs. That is counter to the land-grant concept, it is counter to what we should be striving for in educational policy, and it is counter to what is fair for the families and students at Penn State.

I am very glad to add my testimony to today's hearing. I hope the Committee members will agree with me that although this legislation is a relatively small step legislatively, it is a very big step to Penn State and the students attending the University. I urge your favorable consideration of H.R. 2504.

Mr. FLIPPO. Our next item is H.R. 3096, introduced by Mr. Stark to amend the Internal Revenue Code of 1954 to prevent certain abuses involving tax straddles and to prevent the avoidance of accumulated earnings tax through the use of foreign corporations.

Here to testify with regard to this bill is the Hutton Commodity Reserve Fund Ltd., Mr. Vogel, counsel, accompanied by Mr. Christian.

You can introduce the other members of your panel.

We are delighted to have you here today and we are pleased to receive your testimony. Please proceed as you deem appropriate.

STATEMENT OF EUGENE L. VOGEL, COUNSEL, HUTTON COMMODITY RESERVE FUND LTD., ACCOMPANIED BY ERNEST S. CHRISTIAN, JR., CO-COUNSEL

Mr. VOGEL. Thank you, Mr. Chairman.

My name is Eugene Vogel. I am an attorney representing the investors in the Hutton Commodity Reserve Fund. At my right is Mr. Christian, who is acting as co-counsel to the fund.

I think our statement has been submitted, and of course it will be made part of the record.

I will try to hit a few high points.

Mr. FLIPPO. We will include the entire statement in the record.

Mr. VOGEL. Thank you.

Mr. VOGEL. The fund was created in 1982 as a vehicle to permit U.S. and foreign individuals to participate in a mutual fund of sorts in commodity trading, which is often difficult for smaller investors to do on their own. This has proved to be quite successful.

The basic conception was that we would start in the United States and if the sale was successful, then gradually begin to sell in Canada and Europe and Japan. This is precisely what has happened. Some $50 million in shares were sold not to large investors, as some newspaper reports indicated, but to really small investors, about 6,000 or 7,000 of them, which average about $8,000 of investment each.

The fund formed in the British Virgin Islands with principal office in the Bahamas, and considering that the plan was both to have U.S. and foreign shareholders and that the commodity trading which underlies this operation would be both in New York and on other commodity exchanges in the United States and abroad, we felt there was no choice really and certainly it was not inappropriate to form an offshore entity that would be sort of neutral turf, as it were, for a German or Japanese investor, Canadian or what have you.

We found before that there was sales resistance to commodity pools or funds sold just to Europeans, because they said, "Where are the Americans? Why aren't they in our pool?"

Similarly, there was resistance in selling Europeans into an American entity like a partnership where they are advised, probably correctly, that they are needlessly getting themselves involved in the U.S. tax system.

So that was the basic structure.

Now, we ought to make it very clear, and I don't think anybody doubts it, that this fund does not pertain to timing losses or straddling or anything of that kind. It is 100-percent economic. We are looking for commodity gains and if there are commodity losses that will cost investors money.

In fact, there are no tax loss advantages at all. If there are commodity losses, the losses are realized in the worst possible way for tax purposes. That is, you don't get a loss passthrough to your tax return until you get out of this investment, and then probably just as long-term capital losses.

So it is hardly a straddle or a shelter. The prospectus so states, and I just want to make sure that the fund is distinguished from anybody in that category. Since that—straddle losses—was the principal thrust of the provisions in 1981 that Senator Moynihan sponsored and were included in the commodity trading tax laws in 1981, and since we don't intersect with those, my personal opinion is there has been a certain amount of overreaction by some parties to what the fund is doing as being some kind of very bad thing. We don't think it is.

Remember that once we are satisfied that the fund is not involved in any kind of straddling problem—which it is not—that we are not finding any way to produce artificial losses, then the fund is not really working at cross purposes to any major policy in the 1981 Tax Act.

The problem in 1980, for example, was that traders who usually are in and out of the futures market in months or weeks always have short-term gain and paid 50-percent rates. They did not pay very much in taxes, frequently, because they often used commodity straddles to produce losses.

That latter practice has been stopped and we applaud that it was stopped.

In return, the Moynihan proposals provided for a 32-percent rate. Now, that was not a stringent antitaxpayer provision. That was protaxpayer. And yet I find it odd that I am sitting here defending a fund because it is not taking advantage of a protaxpayer provision.

Now, it is not quite that simple. What we are really doing is using the corporate form and we are having all the pluses and minuses of being in corporate form. That is, you sell your stock in 3 weeks, you have a short-term gain—50-percent note. If you were in the commodity market and you got out in 3 weeks, you would have part short-term gain and part long-term gain under the current law—32 percent.

By the same token, in the actual case of the Hutton Fund, unfortunately the fund's advisors have not as yet made make good investment decisions. We don't like to brag about this, but it is true. The fund has had losses to date and the losses have not been deducted on any U.S. person's tax return. They have not been able to be, because the U.S. investors merely own stock in a corporation.

If the fund had been in the more conventional partnership form, these people would have had market-to-market capital losses, some short term, some long term, as of December 31, 1982, and this would have cost the U.S. Treasury money. So, just ironically, at this moment in time at least, the fund's format has augmented the U.S. Treasury by its existence. Although I do not request a medal on behalf of the fund for that, it is instructive as to how this is quite a balanced situation.

Now, section 3 of the bill as proposed is an antistraddle provision—and since we don't believe we have any straddle problems, we are quite content to have section 3 enacted; we do not object to it. We have some small concern on how a too broad definition of this provision will work, but you will hear from us if we are concerned about that, otherwise, no problem.

Now, as to the remainder of the bill, we think is rather stringent. It takes people who went into this fund in 1982 and turns what was either potential for long-term gain or, at worst, 32-percent rates, into ordinary 50-percent rates. That is what the proposal does under section 1246.

Also, the accumulated earnings tax provision, to the extent it would apply to this fund, would impact on foreign shareholders who had no intention of getting involved in the American income tax or accumulated earnings tax. We frankly don't think either one of these provisions are necessary to protect the Treasury, or ideas of tax fairness. What we have here should be recognized as a natural offshore investment vehicle for truly international activities. There is no secrecy whatsoever, everything is absolutely above board, with a prospectus filed with the SEC.

If, nevertheless, Congress determines that H.R. 3096 should be enacted, at the very least, we are making a plea on behalf of the 6,000 or 7,000 relatively small investors in the fund who in good faith invested in this, and in 1982, long before they dreamed of any of this. They invested based on what the law then was, which I personally stood behind, and which no one really doubted. Under these circumstances there should be transitional rules that would permit them to realize the potential they had when they committed their funds under the then rules of the game, and some reasonable time to get out with an orderly market. This is so even if H.R. 3096 stops dead in its tracks any future funds of this kind. We have in our statement given some ideas on transitional rules and have also discussed those with the staff in the past. I hope they are given consideration.

Thank you.

[The prepared statement follows:]

STATEMENT OF EUGENE L. VOGEL ON BEHALF OF HUTTON COMMODITY RESERVE FUND LIMITED

SUMMARY OF POINTS

(1) The Hutton Commodity Reserve Fund Limited (the "Fund") was created in 1982 to enable the small and middle size investor to participate in speculative commodity trading. The intention was and is to make a trading profit for the shareholders. (To date there have been losses, and there is, of course, no way to assure that any profits will be realized in the future.)

(2) The basic concept of the Fund was to start primarily with United States shareholders, then sell shares throughout the rest of the world and gradually turn it into a truly international fund. Commodity trading was and is to be conducted both in the United States and in markets outside the United States. Under such circumstances, a neutral offshore base was perfectly appropriate and proper.

(3) The Fund is to no extent a vehicle for engaging in commodity straddles or any other kind of tax shelter and the prospectus so states.

(4) If the Fund provides certain tax advantages for a U.S. investor which might adversely affect the Treasury, it conversely has certain tax disadvantages which might favorably affect the Treasury; in any event, it was established and its shares sold in accordance with the well established, albeit complex, pattern of the tax law as it existed then and exists now.

(5) H.R. 3096, in seeking to convert commodity gains realized by Fund investors to ordinary income and, in effect, imposing U.S. taxes on foreign investors, can be viewed as punitive. At the same time, H.R. 3096 will have no significant effect on U.S. tax revenues, will add additional complexity to the Code, and may work at cross purposes with the policy of the Code provisions with which it intersects. Accordingly, we oppose the enactment of H.R. 3096 as now proposed.

(6) To avoid obvious abuses, Section 3 of H.R. 3096 dealing with straddles may be required. It has no bearing on the operations of the Fund and we have no objection to it.

(7) If, however, it is considered necessary to enact all of H.R. 3096 as now proposed, it should be stressed that many thousands of persons, beginning in October 1982, have been investing in the Fund in good faith on the basis of the law as it exists. It would be unfair and contrary to general principles now to enact the Bill without appropriate transition rules which would exempt current investors from its onerous provisions.

STATEMENT

Mr. Chairman, my name is Eugene L. Vogel of the law firm of Rosenman Colin Freund Lewis & Cohen of New York, New york. I am accompanied by Ernest S. Christian, Jr., of the law firm of Patton, Goggs & Blow of Washington, D.C. It is a pleasure to appear before this Committee.

H.R. 3096 would have a major impact on the Hutton Commodity Reserve Fund Limited (the "Fund") for which I have served as legal counsel.

The Fund was organized in 1982 to engage in worldwide commodity trading. The structure consists of a parent corporation and subsidiary both incorporated in the British Virgin Islands with their principal offices in the City of Nassau, Bahamas.

The basic conception was that shares in the Fund would be sold to United States investors and, assuming the sale was successful, sales of shares would then commence in Canada, Europe and throughout the world. The sale to U.S. investors was successful, with some $50 million invested, and in fact sales outside the United States have been and are now proceeding as planned. The idea for the creation of this international commodity "mutual fund" arose in part from the sales resistance which was experienced a few years ago in connection with an all-foreign investor fund. The typical foreign investor was wary of investing in a fund in which there were no U.S. investors joining in.

The Fund was not designed for large wealthy investors. To date, some 6,500 persons have bought shares in the Fund with each investment averaging only $8,000. Some investors were Individual Retirement Accounts each of which invested $2,000.

Considering that the ultimate goal was to have shareholders from all of the major nations of the world and that commodity trading would be conducted both in the United States (through the subisidiary) and outside the United States (through the parent company), it was customary and appropriate, if not necessary, to pick a neutral offshore domicile for the Fund. For example, among other reasons, foreign shareholders would not ordinarily wish to invest in a U.S. based fund because of the risk of U.S. estate or inheritance tax difficulties.

Although tax considerations had to be considered in the creation of the Fund, it certainly was not set up for tax avoidance or tax shelter purposes. The Fund invests in various commodity contracts with trading decisions made by six trading advisors each unrelated to the other. At any given point in time, no one is aware of the Fund's current commodity positions. As a result, no investor could possibly "straddle" the Fund's positions with his own positions. The investors in the Fund will only benefit if the commodity transactions in the Fund actually produce an economic profit. Any losses would be real economic losses and would be realized in the most disadvantageous way possible for tax purposes; i.e., only when shares of the Fund are redeemed, and, for most shareholders, as a long-term capital loss.

Section 3 of H.R. 3096 is designed to stop the use of foreign corporations to circumvent the anti-straddle rules of the Internal Revenue Code enacted in 1981. As indicated, this has no bearing on the operations of the Fund or its shareholders, and we have no objection to the enactment of Section 3 in order to crub the abuses contemplated by it.

The Fund, as a foreign corporation engaged in commodity trading in the United States (and elsewhere), is not subject to U.S. taxes on the commodity trading as is the case generally with any foreign corporation or other person, and U.S. shareholders in the Fund, since they are not holding positions in commodities but only shares in a corporation, are not subject to the recently enacted special rules on trading in commodity futures.

However, the effect of this is not necessarily all one way and, in any event, none of this, in our view, has anything to do with the perceived abuses that led to the 1981 commodity taxing rules. We remind the committee that, except for taxpayers attempting to create straddle losses, the mark-to-market, 60 percent/40 percent tax scheme now in effect for commodity transactions can be either advantageous or disadvantageous to a given taxpayer. It would be quite advantageous in realizing actual losses currently, partly as short-term losses and partly as long-term losses. A U.S. investor in the Fund foregoes this potential advantage and has no loss deduction at all while holding his shares. When he sells his shares, if there is a loss, he has only long-term losses and only in the year of sale. In fact this has been the current situation. The Fund is in a loss position to date, and, to the advantage of the U.S. Treasury, the shareholders have not been able to take any tax deductions for their losses whereas if the Fund were onshore and set up in limited partnership form, the investors would have had losses passed though in the 1982 taxable year and so far for the current year. Of course, if the Fund moves into a gain position (which is by no means assured), U.S. shareholders would likewise not have any tax liability until they redeem their shares and then would probably be taxed at long-term capital gain rates. Under the circumstances, we consider this to be an entirely reasonable tax/investment choice of the type that pervades our tax system as well as being the correct result under the present tax laws.

Turning now to the impact of H.R. 3096, we point out that the Fund was formed to attempt to generate gains from commodity trading activities and not interest or other forms of ordinary income. However, Section 1 of the Bill would convert any gains from commodity trading, which are currently taxed at rates of up to 32 percent, to ordinary income taxed at rates of up to 50 percent. To that extent, the provisions of the Bill seem punitive. The U.S. shareholders of the Fund should certainly pay no more than the rate of taxation that would be applicable if their commodity investments were made directly or through a U.S. limited partnership.

The operation of Section 2 of H.R. 3096—the accumulated earnings tax section—is punitive to the Fund's foreign shareholders. As indicated, the Fund was designed as an international investment vehicle. The accumulated earnings tax (being a corporate level tax) dilutes all shareholders' (U.S. and foreign) equity equally. Accordingly, the application of the accumulated earnings tax to the Fund will unfairly penalize foreign shareholders, who would otherwise never have been subject to any U.S. tax if they made a direct investment in the U.S. commodity markets.

Furthermore, we questions whether a widely held international fund seeking capital gains is an appropriate or effective target for the accumulated earnings tax (where long term gains and losses are, under the Code, deleted and deducted, respectively, from the tax base) or whether the complexities and uncertain reach of the change contemplated by Section 2 is, in any event, necessary if Section 1 with its sharp impact becomes law.

If enacted, H.R. 3096 would also impose intolerable record keeping requirements on the Fund. For example, since the proposed accumulated earnings tax amendment of Section 2 would impose a corporate level tax on the Fund, a tax reserve would have to be established as a reduction to net asset value. The determination of the amount of the reserve would be nearly an impossible, task, although some attempt would have to be made in order equitably to charge redeeming shareholders with their proportionate burden of the tax. In addition, complex earnings and profits records and calculations for each shareholder would be required under proposed Section 1.

If the Code is ultimately amended as now proposed in Sections 1 and 2 of H.R. 3096, the structure of taxation of foreign corporations with widely held U.S. and foreign shareholders will be altered and the current provisions which expressly facilitate commodity trading on U.S. markets by foreigners will be in part reversed. If such changes in law are enacted, they should certainly contain appropriate transition rules which will assure fairness to the investors who in good faith (which no one questions) invested in the fund in 1982 and 1983 on the basis of the tax law then in effect.

We propose that the provisions of subsection 1(a) that impose tax at ordinary income rates on shareholders would not apply to sales or exchanges of, or distributions with respect to, shares purchased by that shareholder before date of enactment, where the issuing corporation was formed and actively engaged in business and/or trading operations prior to January 1, 1983. This transitional rule would avoid harsh treatment for the early shareholders of the Fund by affording them the opportunity to realize a return on their investment which can only arise from the continuing ongoing operations of the Fund which at present is in a loss position. (We have suggested date of enactment, instead of May 23, 1983, not because there are significant sales or planned sales of shares in the Fund to U.S. persons between these dates. Nevertheless, there are some minor sales continuing and the date of enactment effective date would avoid the practical and administrative difficulties of having to stop sales prematurely, of having to keep separate earnings and profits records for only a handful of shareholders, or of having to rescind their purchases.)

Along these same lines, we propose that subsection 2(a) relating to the accumulated earnings tax would, in the case of a corporation that was formed and actively engaged in business and/or trading operations prior to January 1, 1983, apply only to distributions on or after January 1, 1986, in taxable years ending on or after January 1, 1986. This transitional rule would avoid for a reasonable time any penalty tax on earnings from commodities transactions in the Fund, and, thus, is an appropriate corollary to the proposed transitional rule for shareholders which is designed to afford them the opportunity to realize a fair return on their investment under the "rules of the game" in effect when their funds were committed.

As indicated, we do not believe that H.R. 3096 is necessary or appropriate (other than possibly the anti-straddle provisions of Section 3). At the same time, we urge on behalf of the investors and the Fund, at the very least, your favorable consideration of the suggested transition rules which we are confident would have no measurable revenue effect at all, would give the investors a fair opportunity on their investment, and would be consistent with general principles.

Thank you for giving us this opportunity to discuss these matters with you.

Mr. FLIPPO. Thank you, Mr. Vogel, for your testimony.

Mr. Schulze.

Mr. SCHULZE. I have no questions.

Mr. FLIPPO. Gentlemen, we do appreciate your testimony very much. Thank you.

Mr. VOGEL. Thank you.

Mr. FLIPPO. The committee is going to stand in recess. We have a vote on the floor. We wish to return.

[A short recess was taken.]

Chairman STARK. The Chair apologizes for the absence of members. At this point if we don't have an absence of witnesses we will continue.

Is Mr. Matland here?

Mr. MATLAND. Yes sir.

Chairman STARK. If you would like to come to the witness table, Mr. Matland. You are counsel for the Association of Private Pension and Welfare Plans and you are here to testify on H.R. 3592, along with Martin Schwartzburg. Is Mr. Swartzburg here?

Mr. SWARTZBURG. Yes.

Chairman STARK. I apologize for the delay and you all may proceed in any order or fashion you desire as soon as you are comfortably settled.

In the absence of any other members, I guess we will start with Mr. Schwartzberg.

STATEMENT OF MARTIN C. SCHWARTZBERG, PRESIDENT, C.R.I., INC., ON BEHALF OF THE COALITION FOR LOW AND MODERATE INCOME HOUSING, AND THE NATIONAL LEASED HOUSING ASSOCIATION, ACCOMPANIED BY HERBERT F. STEVENS, COUNSEL

Mr. SCHWARTZBERG. I think I will begin first.

Mr. Chairman and members of the committee, my name is Martin Schwartzberg. I am president of C.R.I., Inc., a company located in Rockville, Md., which has assembled a portfolio exceeding $2 billion of low- and moderate-income housing developments. I am appearing here today in my capacities as chairman of the Coalition for Low and Moderate Income Housing and on behalf of the National Leased Housing Association. I am accompanied by counsel for both organizations, Mr. Herbert F. Stevens of Lane and Edson, in Washington, D.C.

The coalitions represent all aspects of the industry.

My remarks will be brief. They will address that section of H.R. 3592 relating to the disallowance of accrued interest deductions by partnerships to related persons. This section of the bill will have a significant, adverse impact on rental housing.

As you know, there has been for many years a great shortage of rental housing for low- and moderate-income people. That shortage continues unabated today.

For over two decades, Congress has attempted to subsidize the production and operation of such housing in a variety of ways. These subsidies have taken two courses: direct subsidies, such as section 236 and section 8 and indirect subsidies, through tax incentives.

During the past 2 years, substantially all of the direct subsidies have been phased out by the administration and by Congress. Accordingly, the only meaningful subsidies remaining are those provided through tax incentives.

Fortunately in 1981, at approximately the same time that direct subsidies began to be phased out, Congress was enhancing the tax incentives for rental housing, principally through adoption of ACRS and the extension of that system to existing as well as new construction.

Were it not for these actions on the part of Congress, it is highly unlikely that there would be any low and moderate income housing industry today, and the existing housing stock would be deteriorating rather than being improved and recycled. Indeed, it is the recycling of existing housing stock which has done the most lately to deal with the nation's housing needs, both low income and conventional.

A study completed just recently by HUD supports this.

The process of preservation and revitalization of the existing housing stock requires new capital. This capital infusion is carefully reviewed by HUD.

In its review procedures, HUD has explicitly understood the importance of retaining the existing development team recognizing that in the last 15 years a new private sector expertise has arisen. It is important to preserve this expertise.

In raising new capital, a portion of the purchase price for the development is paid with a deferred, interest-bearing note. However, since governmental restrictions permit low-income housing projects to have only a limited cash return, there is normally not enough cash to pay interest currently on these notes. Interest will have to accrue until it is paid at some fixed time in the future.

Here is where the bill will have a very negative impact. Where a partnership executes a deferred note as part payment for an existing development and one of the note recipients is a partner in the new ownership entity, the bill would disallow the accrued interest deduction, significantly reducing the cash portion which provides much of this revitalization.

Investors, of which there are well in excess of 1 million, view investments in rental housing as yielding significant tax benefits and long-term capital gain through appreciation, recognizing that tenants in rental apartments cannot be the group providing cash flow yields.

We believe that the bill should not apply to this situation.

We propose a "small partner" exception. The proposed rule would permit deduction of accrued interest or fees to cash basis partners and related persons where the partner has a less than 10-percent interest in the partnership. This exception should apply to all rental housing.

This 10-percent standard is consistent with the standard set by Congress for the antichurning rules under ACRS.

If after implementing this small-partner exception, there is still a concern regarding large accrued interest deductions, it would, of course, be possible to limit accrued interest. Rate could be established by the Treasury Department similar to those imputed interest rates under other provisions of the Internal Revenue Code. Those rates presently range from a low of 10 percent to a high of 12 percent.

If the bill is enacted as proposed, it would apply to taxable years beginning after December 31, 1983, no matter when the obligation to pay such interest or fees arose, thus causing havoc to the many transactions already completed under the existing law.

I would urge the committee to exclude from the rule all contractual obligations prior to the date of enactment.

Despite the beneficial effects on tenants and on the preservation of our existing housing stock, it is sometimes argued that these tax incentives result in a loss of Federal revenues. A recent analysis concludes that in fact it does not. For every buyer who takes ACRS deductions, there is also a seller reporting ordinary income and capital gain.

In summary, Mr. Chairman, we believe that the present tax incentives directed at the maintenance and revitalization of the existing rental housing stock are vital to the process and, indeed, are the only such incentives left. Moreover, we agree with HUD that these tax incentives not only do the job, but, in the long run, the economic benefits of them accrue to the renters and preserve our Nation's diminishing housing stock. In addition, these resyndications are at little or no cost to the Treasury.

Accordingly, Congress should not bring these resyndications inadvertently into the rules on the disallowance of interest and expenses.

Thank you.

[The prepared statement follows:]

STATEMENT OF MARTIN C. SCHWARTZBERG ON BEHALF OF THE COALITION FOR LOW AND MODERATE INCOME HOUSING AND THE NATIONAL LEASED HOUSING ASSOCIATION

Mr. Chairman and members of the committee, my name is Martin C. Schwartzberg. I am President of C.R.I., Inc. a company located in Rockville, Maryland, which has a portfolio in excess of $2 billion in low and moderate income housing developments. We act as developers and syndicators of all types of government assisted low and moderate income housing. I am appearing here today in my capacities as Chairman of the Executive Committee of the Coalition for Low and Moderate Income Housing and on behalf of the National Leased Housing Association. I am accompanied by counsel for both organizations, Mr. Herbert F. Stevens of Lane and Edson, P.C., Washington, D.C.

The Coalition for Low and Moderate Income Housing brings together in a single coalition all associations, trade groups, business organizations, and individuals, as well as associated professionals, involved in the private financing, production, rehabilitation and operation of government assisted low and moderate income multifamily rental housing. The Coalition works with the Administration, Congress, state governments and others in an effort to promote the financing, production, rehabilitation and operation through private enterprise of low and moderate income housing in the most effective ways possible. It is constantly seeking new and better methods for accomplishing that objective.

The National Leased Housing Association is an organization of approximately 800 members, which represents almost all aspects of the industry associated with the development, construction, ownership and operation of low and moderate income multi-family rental housing subsidized through the various federal housing programs. It consists of builders, developers, management companies, syndicators, public housing authorities, state housing finance agencies, non-profit organizations, investment banking firms, architects, lawyers, accountants, and virtually every other profession, occupation and organization involved in this area of business.

Together, the two organizations encompass virtually this entire field of endeavor, and thus can speak about it with a considerable amount of confidence and authority.

My remarks will be brief. They will address that section of H.R. 3592, introduced by Chairman Rostenkowski and Mr. Conable, which relates to the allowance of deductions by partnerships for interest and business expenses where the payments which are made to related persons are deferred until a later year. This section of H.R. 3592 will have a significant, adverse impact on low and moderate income housing.

TAX INCENTIVES FOR LOW- AND MODERATE-INCOME HOUSING

As you know, there has been a great shortage of multi-family rental housing for families and individuals of low moderate income for many years, and that shortage continues unabated today.

For over two decades, Congress has attempted to subsidize the production and operation of such housing in a variety of ways, but all of the subsidies have taken two basic courses: direct subsidies, such as the Section 236 and Section 8 subsidy programs; and indirect subsidies, primarily through incentives contained in the federal income tax law.

During the past two years substantially all of the direct subsidies have been phased out by the Administration and by Congress. The Section 8 housing program, which at one time was responsible for the production of over a hundred thousand new or substantially rehabilitated dwelling units per year, no longer exists for newly constructed housing and most other direct subsidy programs fostering new construction have been drastically reduced or eliminated as part of the domestic budget cuts. Accordingly, the only meaningful subsidies remaining are those provided through the Internal Revenue Code.

Fortunately, in 1981, at approximately the same time that direct subsidies began to be phased out, Congress was enhancing the tax incentives for low and moderate housing, principally through adoption of the Accelerated Cost Recovery System and the extension of that system to existing as well as new construction. Were it not for these actions on the part of Congress, it is highly unlikely that there would be any production of low and moderate income housing today, and the existing housing stock would be deteriorating rather than being improved and recycled. Indeed, it is the recycling of existing housing stock which has done the most lately to deal with the nation's housing needs, both low income and conventional. The conversion to housing of buildings originally built for another use, such as warehouses, hospitals and office buildings, and the renovation of existing apartment buildings are creating much of the housing stock of this country today, particularly in the older states and cities.

At this point, Mr. Chairman, I would like to invite your attention to a study completed just recently, in December, 1982, by the Office of Economic Affairs of the Office of Policy Development and Research of the Department of Housing and Urban Development (HUD). A copy is attached as Exhibit B to this statement, and I ask leave to include this study in full as an exhibit to my testimony. It is entitled "Federal Tax Incentives and Rental Housing." This HUD study concludes that the changes made by the tax law in 1981, which extend tax benefits equally to existing and new housing, could "result in a reduction of economic depreciation and longer economic life for existing rental housing units. Longer economic life may result in decreases in housing abandonment and demolition and retention of more older units in the inventory." (p. iii).

SYNDICATION OF EXISTING PROPERTIES

The process of preservation and revitalization of the existing low and moderate income housing stock takes place usually through a transfer of an existing housing development owned by a limited dividend partnership to a new limited dividend partnership which infuses new capital into the development. This transfer is reviewed by HUD, or another federal or state agency, and may not take place unless the governmental agency approves of both the management of the housing development and the financing arrangements, including the uses to which the new capital will be put.

HUD has explicitly recognized in its administrative procedures regarding the transfer of these properties, that those persons who own and manage the properties can be retained as general partners of the new partnership which is buying the property. If these persons are retained as general partners of the new partnership, the HUD procedure is far less costly, time consuming and far less complicated. If the old owner managers are not included in the new partnership, HUD must review and evaluate the qualifications of the new owner/managers more thoroughly; hence the more favorable administrative treatment for projects which retain existing owner/managers. This is also consistent with the fact that in the last 15 years a new expertise has arisen in those housing developers which manage low income housing. Because the problems of managing low income housing are special, it is important to preserve this expertise at the same time that the existing low income housing stock is revitalized.

IMPACT OF H.R. 3592

In order to ensure that more of the new capital which comes from a new syndication of a low income housing project will benefit the tenants of that project, rather than the sellers, it is necessary that a significant portion of the purchase price be paid with a purchase money note of the new partnership. The use of these purchase money notes is also consistent with conventional real estate financing. However, since governmental restrictions permit low income housing projects to have only a limited cash return after payment of debt service on an existing mortgage, these purchase money notes will have to accrue interest which will not be paid until some fixed time in the future, or upon the sale or refinancing of the property. Where a partnership executes a purchase money note as part payment for an existing low income housing project and one of the payees is a partner in the new partnership, H.R. 3592 would disallow either all or a part of the interest deduction with respect to this note, significantly reducing the cash portion which provides much of this revitalization.

As stated previously, all of the financial arrangements between the new partnership and the old owner/managers are reviewed by HUD or another federal or state agency. The amounts of these notes, and the accrual of interest thereon, must be approved by the governmental agency and must be supported by the value of the project. Normally, these owner/managers will not be given a major share of the ownership of the new partnership. Nevertheless, H.R. 3592 would apply to any interest or fees which are ultimately paid to these partners.

We believe that H.R. 3592 should not apply to the situation I have just described—where HUD or another governmental agency approves the financial arrangements with respect to the transfers of existing low and moderate income housing. Otherwise, the tax benefits Congress has recognized as crucial to the low and moderate income housing programs will be reduced and the revitalization will be greatly hindered. One solution would be to have the rule of H.R. 3592 contain a "small partner" exception. The proposed rule would not apply to any accrued but unpaid interest or fees to cash basis partners and related persons where the partner has 10% or less of the interest in capital or profits of the partnership. This exception should apply at least to all residential housing. Because of the great variety of low and moderate income housing which exists, including housing construction and rehabilitation by non-profit agencies and corporations where the usual governmental assistance is not present, this exception should not merely be limited to "low income housing" as presently defined in the Internal Revenue Code.

This 10% standard is consistent with the standard for the "anti-churning" rules under the Accelerated Cost Recovery System. When Congress enacted the Economic Recovery Tax Act of 1981, it allowed the ACRS system to apply to purchases of existing properties so long as the seller retains only a 10% or less interest in the property. Similarly, HUD has recognized the benefits of owner/managers of existing low income housing projects continuing to be partners of the new partnerships owning the projects. An exception for the partners, or related persons, owning 10% or less of the capital or profits of the new partnership would allow the syndication of existing low and moderate income housing projects to continue.

If after implementing this "small partner" exception to the proposed rule, there is still a concern regarding large accrued interest deductions, it would of course, be possible to amend the proposed rule to permit accrued interest to be deductible provided that it does not exceed the rate provided by the Treasury Department for certain "imputed interest" rates under other provisions of the Internal Revenue Code. Those rates presently range from a low of 10% to a high of 12%, and they are adjusted periodically by the Internal Revenue Service.

RETROACTIVE EFFECT OF H.R. 3592

If the H.R. 3592 is enacted as proposed, it would apply to interest and fees which accrue for taxable years beginning after December 31, 1983, no matter when the obligation to pay such interest or fees arose. Thus, previously syndicated partnerships will be subject to its restrictions in the same manner as new partnerships which are organized in the future.

It is inequitable to disallow deductions for interest and fees which were negotiated as part of business transactions based on the law as it then existed. For the reasons discussed above, there are many resyndications of low and moderate income housing in the last two years in which the old owner/managers who have been paid in part with purchase money notes continue to be partners of the new partnerships. In addition, management and development fees which are to be paid to these partners have been accrued by the partnerships even though they will be paid after 1983, all of which is consistent with current tax law. I would urge the committee to exclude from the rule all losses, expenses and interest with respect to which an existing contractual obligation existed prior to the date of enactment of this legislation.

TAX EFFECTS OF PROPOSED CHANGES

Despite the beneficial effects on tenants and on the preservation of our existing housing stock, which HUD has concluded have been conferred by the 1981 Tax Act, it is sometimes argued that these tax incentives result in a loss of federal revenues. However, in the resyndication of existing properties, there should be little or no additional net tax expenditures. For every buyer who takes ACRS deductions there is also a seller reporting ordinary income and capital gain from the built-in appreciation of the property. A recent analysis indicates that resyndication of existing apartment buildings to take advantage of the depreciation provisions of the 1981 Tax Act will have little or no impact on federal tax revenues. Rather than labor the point, I have attached to my statement as Exhibit A a copy of an article published on June 6, 1983, by BNA's Housing and Development Reporter which summarizes that analysis, prepared by David A. Smith of Boston Financial Technology Group, Inc., and I ask that that article be included as part of my testimony.

In summary, Mr. Chairman, the Coalition for Low and Moderate Income Housing and the National Leased Housing Association believe that the present tax incentives directed at the maintenance and rehabilitation of multi-family rental housing for individuals, principally elderly, and families of low and moderate income are vital to that process and, indeed, are the only such incentives left, now that most direct subsidies have been eliminated. Moreover, we agree with HUD that these tax incentives not only do the job, but, in the long run, the economic benefits of them accurue to the renters, and preserve our nation's diminishing housing stock. In addition, as Mr. David Smith has demonstrated, these resyndications are at little or no cost to the Treasury. Accordingly, Congress should not bring these resyndications inadvertently into the rules on the disallowance of interest and expenses contained in H.R. 3592.

EXHIBIT A

HOUSING & DEVELOPMENT REPORTER

Volume 11, Number 2 THE BUREAU OF NATIONAL AFFAIRS, INC. June 6, 1983

BUSINESS AND FINANCE

ANALYSIS SHOWS RESYNDICATIONS WILL HAVE LITTLE IMPACT ON FEDERAL REVENUES

The resyndication of existing apartment buildings to take advantage of the depreciation provisions of the 1981 tax act will have little or no impact on federal tax revenues, according to an analysis by a Boston-based syndicator.

The analysis by David A. Smith of Boston Financial Technology Group, Inc. shows that here will be virtually no additional net tax expenditure for a resyndication without secondary financing. Even with secondary financing, the study says, the cost to the federal government will be relatively low, compared with alternatives to resyndication. In addition, Smith says, resyndication provides capital to upgrade projects and generally brings improved management.

The model used by Smith in his analysis is a 200-unit Section 236 project which went to final endorsement in 1972, with an original cost (debt plus equity) of $17,500 per unit, and which was resyndicated in January 1984 for values ranging from $16,250 to $25,000 per unit. Smith used a federal discount rate of 13 percent in his calculations. He also included certain mortality assumptions on the rate at which original partners would die, resulting in a step-up in basis and forgiveness of gain if the project weren't resyndicated.

Calculating Costs

In computing the net cost to the government of a resyndication, Smith notes, the tax deductions available to the new investors must be offset by the future deductions available to the original owners, in the absence of resyndication, and by the taxes paid by the original owners on the sales proceeds. (Technically, as Smith points out, the amount used in the calculation for taxes is the increased present value of taxes paid now over taxes that would be paid on the eventual sale of the project, if it weren't resyndicated.)

Smith uses three scenarios: a decline in project value to $16,250 per unit at the time of resyndication, with no secondary financing; an increase in value to $22,500, with some secondary financing; and an increase to $25,000, with a larger amount of secondary financing.

Under the first scenario, the analysis shows a net present value of the federal tax expenditure associated with the resyndication of $214 per unit, or 3 percent of the $1.285 million in capital raised through the resyndication. In this case, the taxes paid by the seller offset virtually all of the additional deductions available to the buyers. In the second scenario, the net tax expenditure is $2,068 per unit, or 32 percent of the capital raised, and in the third, the tax expenditure is $2,804 or 44 percent of capital raised.

Even the higher amounts, the report says, are less than one year's Section 8 contract and about half the cost of a mortgage assignment. Therefore, it says, if HUD might have to provide Section 8 assistance to a project or take an assignment, the government would be better off financially with a resyndication.

EXHIBIT B

Federal Tax Incentives and Rental Housing

December 1982

Office of Economic Affairs
Office of Policy Development and Research
Department of Housing and Urban Development

EXECUTIVE SUMMARY

Purpose

The condition of the rental housing market has been the subject of considerable debate during the past few years. Concern has been expressed over a perceived shortage of middle-income rental housing, and the erosion of Federal income tax benefits has been cited as a contributing factor in the decline in unsubsidized rental housing investment. This erosion in the tax advantages accorded to rental housing has been due, in part, to the limitations placed on real estate tax shelters in the various tax reform acts passed during the last two decades. Therefore, the report of the House Committee on Banking, Finance and Urban Affairs accompanying the Housing and Community Development Act of 1980 instructed the Secretary to "conduct a study of the impact of Federal taxation law on rental housing, which shall at least include the impact of Federal tax laws with respect to: (1) the production of new middle-income rental housing; (2) the maintenance and rehabilitation of existing rental housing; (3) the conversion of existing rental housing to condominium or other uses; and (4) tenants residing in rental housing or prospective tenants of rental housing." This report also addresses the potential impact of the Economic Recovery Tax Act of 1981 on rental housing investment.

Organization and Outline

This report begins with a description of Federal tax incentives and rental housing, and the institutional setting underlying rental housing production: the rental housing industry and the principal participants in the industry. The report specifies and describes in detail the Federal tax incentives related to rental housing. This is followed by a description and summary of the major changes in the real estate investment portions of the Economic Recovery Tax Act of 1981 (ERTA).

The next section considers the effects over time of incentives created by the Internal Revenue Code (IRC) on decisions by investors and owners that relate to the production of new rental housing, the maintenance and conversion of the existing stock, and ultimately, to rents charged to tenants. In addition, it considers whether ERTA has restored the tax advantages to rental housing that have been eroded over the past several years. This section addresses the specific issues set forth in the report of the House Committee on Banking, Finance and Urban Affairs.

The Impact of Federal Tax Laws on the Production of New Rental Housing

Federal tax policies have been a major factor in the past in allocating capital investment toward the residential sector. Tax incentives were at least partially responsible for the development of the institutional vehicles for capital accumulation and investment in real estate during the 1970's. For example, the securities industry became a major participant in rental housing through its underwriting and marketing of limited partnership participations and stock offerings.

An analysis of rental housing incentives estimated that the present value to investors in new housing of the pre-1981 residential rental-specific tax incentives was between 10 and 15 percent of the value of a property, not including the longer-term effects of additional capital flows. As a result, an investor in the 50 percent marginal tax bracket would be willing to bid 10 to 15 percent higher for a rental property because of the tax incentives. The present value of the rental-specific tax benefits was increased by ERTA by approximately 9 percent for new buildings and 7 percent for existing buildings for investors in the 50 percent marginal tax bracket.

The Impact of Federal Tax Laws on the Maintenance and Rehabilitation of Existing Rental Housing

The pre-1981 tax laws favored investment in new housing over existing housing and owner-occupancy over rental-occupancy. Analysis suggests that the pre-1981 tax laws may have led to a reduced demand for existing rental housing. Such reduced demand may have increased the rate of economic depreciation of existing rental housing units and was probably one of the factors leading to an increased level of abandonment and demolition of older existing units in the early 1970's.

The 1981 tax law greatly reduces the previous large capital recovery differentials between new and existing rental housing. It encourages a succession of owners for a rental housing property to initiate a new depreciation cycle every 15 years. This could result in a reduction of economic depreciation and longer economic life for existing rental housing units. Longer economic life may result in decreases in housing abandonment and demolition, and retention of more older units in the inventory.

For three reasons, retention of older units in the inventory is not likely to lead to a reduction in the overall quality of the rental housing inventory. First, tax benefits to owners would be swamped by economic losses if succeeding owners permitted their buildings to run down to the point where they cease to be competitive. Second, a reduced rate of inflation can be expected to modify, at least to some extent, the inflation-related view of owner-occupied houses as investment vehicles. An increased demand for rental housing presumably will provide more income to owners for improved maintenance. Third, the 1981 law, in equalizing the depreciation treatment of existing buildings and new buildings, substantially increases the tax incentives for rental housing rehabilitation.

The Impact of Federal Tax Laws on the Conversion of Existing Rental Housing to Condominium or Other Uses

The condominium conversion phenomenon was fueled by the strong demand for homeownership that resulted from the decline in real after-tax homeownership costs in the 1970's. Other factors contributing to the conversion trend included lower profitability of multifamily rental housing ownership due to a lag of rents behind increases in operating and maintenance costs and a proliferation of rent control measures or consideration of such measures by local governments.

The factors underlying the condominium conversion trend may now have changed. ERTA has increased the tax benefits for owners and investors in rental housing. As indicated above, a lowered rate of inflation may reduce the tendency by many people to consider owner-occupied houses as investment vehicles. Apartment vacancies have begun to come down and the market is once again permitting rents to keep pace with inflation. Thus, in addition to the condominium conversion controls which many communities have adopted, conversions may be more limited because of changing market conditions.

The Impact of Federal Tax Laws on Tenants Residing in Rental Housing or Prospective Tenants of Rental Housing

Given the competitive nature of the rental housing market, it is likely that most of the benefits of rental-specific tax provisions accrue to renters. Owners of rental property may benefit by themselves in the short run from a favorable change in rental tax provisions. However, an enhanced rate of return will attract more investment and lead to lower rents than would be obtained in the absence of the favorable change. This may be the scenario resulting from the 1981 tax law as increased rates of return attract additional investment to rental housing. Since renters have lower incomes than other households, tax benefits that lead to decreases in rents tend to be progressive in nature.

The Potential Impact of ERTA on Rental Housing Investment

The 1969 and 1976 rental housing tax provisions reduced the rate of return to rental housing investment and were probably at least partially responsible for a flow of capital investment away from the rental housing sector. The rental housing tax provisions of ERTA have increased the rates of return to rental housing investment.

While ERTA has restored to rental housing investment tax incentives that have been eroded over the past several years, it has also increased tax incentives for investment in commercial buildings and plant and equipment. In some cases the tax incentives provided to commercial and industrial properties under ERTA were greater differentially than those provided to rental housing. The revised tax code still favors investment in rental housing over non-residential properties but less so than before. Because of such countervailing forces, the overall potential impact of ERTA on investment in rental housing is unclear.

The pre-1981 tax provisions, favoring new over existing rental housing and owner-occupancy over rental-occupancy, may have contributed to an increase in the quality of the rental stock. While this effect could reverse under ERTA, other factors may offset such a reversal.

The major factors contributing to the condominium conversion phenomenon may be receding in the 1980's. The favorable rental housing investment provisions in the 1981 tax law and a reduced rate of inflation could be responsible for the change.

It is likely that most of the benefits to owners and investors under ERTA will accrue to tenants in the form of lower rents than would be the case without ERTA.

Federal Tax Incentives and Rental Housing

I. The Multifamily Rental Housing Industry; Institutions and Practices

A. The Multifamily Rental Housing Industry and the Syndication Process

The purpose of this discussion is to provide some background on the development, marketing and ownership of multifamily rental housing. It describes the various major forms of rental housing ownership, with particular emphasis on the growth and development of the syndicated limited partnership and the emergence of Wall Street as a serious participant in the housing industry. This is followed by a description of the specialized syndication process applicable to HUD subsidized multifamily rental housing. It sorts out and identifies the roles of the various major participants in the subsidized housing development process, including the builder-developer, syndicator and investor.

The material on conventional rental housing is based, in part, on the work of Alan Rabinowitz and others.[1] The material on subsidized rental housing is based in part on a study done for the Department of Housing and Urban Development by the Urban Institute,[2] discussions with representatives of law firms specializing in real estate syndications,[3] and other sources.[4]

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[1] Alan Rabinowitz, The Real Estate Gamble, AMACOM, New York, 1980; Theodore S. Lynn, Harry F. Goldbert, and Daniel S. Abrams, Real Estate Limited Partnerships, John Wiley & Sons, New York, 1977.

[2] C. Duncan MacRae and Margery J. Turner, Builder-Developer Decision Analysis, the Urban Institute, 1980.

[3] Caplin and Drysdale and Tucker, Flyer, Sanger, Reider & Lewis.

[4] Stephen E. Roulac, Modern Real Estate Investment, Property Press, San Francisco, 1976; James A. Britton, Jr. and Lewis O. Kerwood, Financing Income Producing Real Estate, McGraw-Hill, New York, 1977; Joseph M. Blew and Howard H. Stevenson, "How to Understand a Subsidized Housing Syndication," Real Estate Review, Summer, 1978.

Investor Types

Different kinds of housing investments attract different types of investors. In general, people who invest in conventionally financed rental housing projects are interested in some balance between cash flow, tax benefits, and capital gain. In the past, such investors could anticipate steadily rising rents to make it possible for them to refinance and cash-out their projects within a relatively short time. However, the high prepayment penalties now required by mortgage lenders and a slowing down of rent increases have tended to result in longer lock-in periods for conventional investors than was true in the 1950's and 1960's.

Investors in subsidized housing projects are usually wealthy individuals in high marginal tax brackets. This was particularly true before the Economic Recovery Tax Act of 1981 reduced marginal tax brackets to a maximum of 50 percent from up to 70 percent on investment income. Such investors are generally interested much more in tax shelter than in cash flow and capital gain. The long mortgage term, high construction period fees and carrying charges, and rapid depreciation produce substantial tax benefits for investors in Federally subsidized housing.[5]

Investment Tiers

Rental housing investments can be thought of as consisting of at least two tiers. Real estate investors with substantial resources and real estate business entities operate in an upper tier where they can compete for properties of all sizes. Large numbers of individual investors operate in a lower tier where their limited resources permit them to compete only for smaller sized properties. Individual investors are generally ill-equipped in terms of resources and background to carry out the sophisticated types of property analysis needed to identify profitable real estate investments in the upper tier. In contrast to securities transactions in which large blocks of stock can be sold only with some difficulty because of their effect on market prices, real estate prices are generally not negatively affected by large scale sales.[6] The greater price competition for smaller properties is said to cause the prices of such properties to be less attractive for investors than those for larger properties.[7]

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[5] Housing in the Seventies, U.S. Department of Housing and Urban Development, Washington, D.C., 1976.

Types of Business Entities

Real estate business entities of various types offer individual real estate investors access to the more attractive first tier of properties, provide sophisticated market and property analysis, professional property management, and in most cases provide a pass-through of depreciation and and other income tax deductions while shielding investors from general liability. Real estate business entities have grown, expanded and matured over the past 30 years and, while statistics are not available on market allocation in the real estate industry by type of organization, business entities other than individual investors or individual proprietorships appear to have become a significant factor in the multifamily rental real estate market.

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[6] Stephen E. Roulac, Modern Real Estate Investment, Property Press, San Francisco, 1976, pp. 86-87.

[7] *Ibid.*

The legal ownership form of an investment represents an important consideration for the real estate investor. A single investor or joint tenancy can, of course, hold title to a housing development. While this form of ownership is the least restrictive on the investor and provides for full flow-through of tax benefits, it carries unlimited liability, and is restricted in terms of property value by the resources of the individual or joint tenancy. This form of ownership has declined in favor in recent years.[8]

As with individual ownership, the general partnership is highly flexible and permits full pass-through of tax benefits. It has the same problem as with individual ownership, however, in that each investor is exposed to unlimited liability. For this reason, the limited partnership is the preferred legal form. It has the tax benefit pass-through together with limited liability for the investing partners. As described in more detail below, the limited partnership has two types of partners, general and limited. The general partners carry management responsibility as well as unlimited liability. The limited partners are practically in the role of corporate stockholders. They have no management responsibility and their liability is limited to the amount of their investment.

The corporation, while the dominant form for most large business entities generally, is less favored for real estate ownership than the partnership. This is due to the corporation's disadvantage of being a taxable entity. This not only results in the payment of taxes at the corporate level and on the individual investor level when dividends are received, but it also precludes the pass-through of losses to shareholders to offset income from other sources. A specialized corporate form, the Subchapter S Corporation, offers investors the advantages of limited liability and professional management, and for income tax purposes is treated as a partnership. However, because the amount of loss deductible by a stockholder is limited to the cost basis of his stock plus loans to the corporation by the stockholder, the advantage of the pass-through of accounting losses to the investor is sharply curtailed.[9] As a result, the Subchapter S Corporation has limited usefulness as a real estate ownership form.

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[8] Ibid, pp. 264-272.

Development, Growth and Decline of Large-Scale Ownership Institutions

Until the middle 1950's, there were not many opportunities for investors to participate in real estate ownership except as individual owners or general partners, or as stockholders in one of the handful of real estate companies that survived from the 1920's. These were augmented by a few highly speculative corporate enterprises such as Webb and Knapp and General Development Corporation. By the end of the Korean War, an understanding of the growing United States international commitments and defense requirements began to emerge among investors and businessmen. It became increasingly clear in the investment community that Federal tax rates would not drop back to earlier levels. As wealthy individuals and businessman sought legitimate means to shield part of their income from taxation, many found that real estate represented an excellent vehicle for this purpose.[10] A small number of syndicated partnerships and real estate corporations were founded in the late 1950's but the falling share values and severe losses to investors in the 1962 recession temporarily halted the growth of such enterprises. By 1970, however, encouraged by the Housing and Urban Development Act of 1968 (Section 236) and the Tax Reform Act of 1969,[11] a number of Wall Street firms entered the business of creating tax shelters for their wealthy customers.

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[9] James A. Britton, Jr., and Lewis O. Kerwood, Financing Income-Producing Real Estate, McGraw-Hill, New York, 1977, pp. 112-113.

A significant move by Wall Street into the creation of tax shelters for investors was the acquisition by Merrill Lynch in 1968 of Hubbard, Westervelt and Mottelay, Inc., an old line real estate firm. In addition, E. F. Hutton and Company and Paine Webber Jackson and Curtis, Inc., entered the field. Paine Webber, through its Boston Financial Technical Group, rapidly financed $350 million in apartments and other real estate through private syndicated placements with projections in 1972 of about $40 million per year for the next four years. Morgan Stanley formed Morstan Development Company to develop real estate projects. Soloman Brothers formed a partnership with R. H. Lapin and Company. Hayden Stone, Inc., entered a partnership with Arlen Realty and Development Corporation to develop real estate projects. Donaldson, Lufkin and Jenrette, Inc., through its subsidiary, the Sommer Development Company, financed a $120 million apartment complex as well as a recreation community and college housing.[12] By the early 1970's, not only had Wall Street entered the field in a major way, but there was a specialization identified within the field. This was best described by an officer of Lazard Frères in 1972 as the tax shelter business, not the real estate business. Because of the capital restrictions set by the New York Stock Exchange and the Securities and Exchange Commission, Lazard Frères stated, most investment houses did not have the excess cash available to underwrite the liabilities of large-scale real estate development projects.[13]

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[10] Alan Rabinowitz, The Real Estate Gamble, AMACOM, New York 1980, pp. 159-231. Mr. Rabinowitz's research was a major source for this section of the study.

[11] In 1969, Congress added Sec. 167(j) to the Code, limiting depreciation on new commercial buildings to 150 percent declining balance and on used commercial buildings to straight line. New residential rental property was not made subject to this limitation and, with its double declining balance depreciation rate, became much more attractive for tax shelters than commercial buildings. In addition, Sec. 167(k) was also made a part of the Code in 1969, permitting a 5 year return of capital for qualified residential rehabilitation investments.

The lure of tax shelters for wealthy individuals and real estate marketing profits for Wall Street made real estate project assembly and development a profitable target area. Foreign investors were attracted to real estate investments in the United States to such an the extent that

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[12] Alan Rabinowitz op cit.

[13] Shirley L. Benzer, "Real Estate Lures Wall Street," The New York Times, August 27, 1972, Sec. 3, p. 4.

Eastman, Dillon, Union Securities and Co., one of the largest real estate financing firms on Wall Street, announced that its real estate subsidiary, Eastdil Realty, was considering the management of European capital pools available for real estate investment in this country.[14]

What emerged as the vehicle for participation in real estate ownership during this period of growth was a limited partnership business form that resembled a corporation except for tax purposes. These limited partnerships had two principal forms, the private placement and the public syndicate. The private placement became the major vehicle for tax shelter investments. Its offering and reporting requirements were less stringent than those of public syndicates and they could more easily be placed with high tax bracket investors in relatively large participations through recommendations of tax counselors and accounting firms. As a result of the 1969 Tax Reform Act, extremely liberal recapture benefits were available only for assisted low-income housing. If a project were held for 10 years, none of the capital gains on sale attributable to depreciation deductions could be converted to ordinary income. In addition, builder-developers were able to build projects with no money. They raised equity by selling future tax losses to limited partners in exchange for cash investments in the partnership sufficient to provide the funds necessary to make up the difference between HUD insured financing and full construction costs.[15] Wall Street became attracted principally to the private placement tax shelter real estate deals. They were profitable to the financial houses that marketed them, practically sold themselves, and functioned around a single project, a known quantity as opposed to the blind pool which characterized the public syndicates.

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[14] Ibid.

The new investment climate was described in a contemporary account as follows:

> About 280 (investors) have pumped $5-million into a deal to build garden apartments in California and Illinois. The deals go on and on into hundreds of millions of dollars but the name of the game is always the same -- how to save money through tax shelters.
>
> Although such tax shelters are nothing more than glorified tax deductions -- sometimes with an extra twist to make them a gold mine if they hit pay dirt -- an entire new industry has been spawned in the last few years, as stock brokers, bankers, investment counselors, tax advisors, accountants, promoters and dozens of others construct and promote these shelters to meet the demands of the rich and the near-rich.[16]

There were some reservations about the economic value of the tax shelter deals. American Housing Partners, a major sponsor firm, withdrew from inner-city Section 236 projects. A major New York mortgage financer, Sidney Sonnenblick, in 1972 labeled Section 236 projects as money losers for their owners, located in ghetto areas of high vandalism, where extra costs for guards and maintenance work pushed costs far above expectations.[17]

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[15] Shelden Schwartz, "How to Find Tax Shelter as a Limited Partner," Real Estate Review, Summer 1971, pp. 54-59.

[16] Robert J. Cole, "Tax Shelters Come Under Scrutiny," The New York Times, August 27, 1972, Sec. 3, p. 1.

[17] Alan Rabinowitz, Op. Cit., p. 199.

Limited partnerships had become an established marketing product on Wall Street when the first serious problems began to surface. The realities of rental housing development in the mid-1970's began to intrude on the limited partnerships. Construction costs and interest rates that turned out to be higher than originally estimated and rising operating costs, vandalism and vacancies began to take their toll of projects. An example was a Kidder Peabody project outside Worchester, Mass. With high vacancy rates and growing operating costs, it couldn't generate adequate cash and defaulted on its HUD insured loan. First Realty, a major developer and general partner described itself as squeezed between frozen rents and skyrocketing costs as well as a tenants' rent strike. The syndicates, which were highly leveraged, had not been structured to allow for higher than projected construction costs, interest rates, and operating costs.

One after another of the partnerships started to go bad and investors were horrified to learn the consequences of being in a bad deal. In addition to the loss of their entire investments in the partnership, the investors became liable to the Internal Revenue Service for a portion of the income taxes they had avoided in the previous years of the partnership.[18] Probably most frustrating to many investors was the fact that limited partners had even less protection and fewer rights than stockholders. As described by Burton Lehman, a specialist in limited partnership law and a partner in the firm of Baer and McGoldrick, the limited partner in a syndicated deal was almost helpless. Unless the partnership agreement permitted the removal of the general partner, there was little the limited partner could do. If he tried to take an active role, he risked being considered a general partner under law and becoming liable for the debts of the partnership.[19] The problems of limited partnership real estate syndication and those of the subsidized housing industry were already well known by the time the moratorium on Federal housing programs was imposed by the Nixon Administration in 1973.

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[18] Ibid. p 203.

Another ownership form began to emerge and grow rapidly during the same post-1968 period, and practically mirrored the popularity of the syndicated partnership. The form was the Real Estate Investment Trust (REIT). REITs started more than 100 years ago in Massachusetts. They developed there because that state's statutes prohibited corporations from holding real estate for investment purposes, but they did permit trusts to make such investments. The early trusts were closely held but subsequently offered shares to the public.[20] They remained a little known and unpopular type of real estate investment because of a variety of legal problems at the state level. In effect, the modern form of REIT was created in 1960 by the Congress through enactment of Section 856 of the Internal Revenue Code.[21] This Section allowed the formation of a "corporate-like" association, investing exclusively in real estate, which could pass its earnings through to its shareholders without the association itself becoming subject to Federal income taxes.[22]

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[19] Shirley L. Benzer, "New Shakeout in Real Estate Syndicates," The New York Times, March 24, 1974, Sec. 3, p. 2.

[20] Arthur M. Weimer, Homer Hoyt, and George F. Bloom, Real Estate, the Ronald Press Company, New York, 1972

[21] PL 86-779.

REITs were designed as either equity trusts, whose portfolios were principally packages of real estate parcels owned by the trusts, or mortgage trusts, whose portfolios consisted mainly of mortgages -- many of which were high interest construction loans and risky in nature. Beginning in the late 1960's, there was tremendous growth in the later type of trust. These trusts usually loaned funds to owners in the form of short-term development loans which offered higher yields than permanent mortgages. Major banks and insurance companies entered the field, seeing an opportunity to participate in the real estate loan market by utilizing a new source of public capital. The investment objective of the mortgage REITs was to secure a high return on shareholder equity, enhanced by leveraging -- that is, to obtain a higher return on their investments in loans than the costs of their own loans. The mortgage REITs did very well, demonstrating impressive earnings and yields records. Prestigious institutions such as Bank of America, Chase Manhattan, Union Bank, and Wells Fargo entered the field, sponsored such trusts, and greatly enhanced the respectability of the Real Estate Investment Trusts.[23]

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[22] Michael L. Meyer and Richard A. Sprayregen, "Equity Trusts: Real Estate Capitalists of the Seventies," Real Estate Review, Summer, 1973, pp. 81-82.

[23] Ibid.

While there were some similarities, the differences between the mortgage trusts and the equity trusts were significant, particularly in their objectives, financing and market strategies. Equity trusts involved long-term ownership of real estate, a market position very different from the lending function of the mortgage trusts both economically and legally. In addition, they were less speculative in nature. An equity trust was generally financed by shareholder equity plus long-term, secured and non-recourse mortgage debt on the properties. This permitted equity trusts, at least in theory, to cut loose from troubled properties with minimum damage.

The mortgage trusts, however, were financed differently, with shareholder equity representing only a small part of their capital structure. There were usually one or more issues of subordinate debt plus short-term senior debt borrowed from banks, the commercial paper market, or other lenders. Mortgage debt was little used as a source of capital. Mortgage trusts grew more rapidly than the equity trusts, representing about 80 percent of total REIT industry assets by 1975. A composite balance sheet compiled by the National Association of Real Estate Investment Trusts at the end of 1975 showed that 19.3 percent of total capital in the industry was provided by shareholder equity, 43.7 percent by bank loans and revolving credits, 11.0 percent by bank lines of credit in use, 4.0 percent by commercial paper, 1.8 percent senior debt, 9.3 percent subordinate convertible and non-convertible debt, and 10.6 percent mortgages on properties.[24]

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[24] Kenneth D. Campbell, President, Audit Investment Research, Inc., Hearing before the Senate Committee on Banking, Housing and Urban Affairs, 94th Congress, 2nd Session, May 27, 1976, p. 26.

The equity trusts benefited from the operating record and growing popularity of the mortgages REITs, as the distinctions between the two undoubtedly became blurred to many small investors, fortunately for them as it later turned out. A report by the Securities and Exchange Commission noted that the real estate investment trust industry experienced more rapid expansion than any financial institution in history.[25] In the generally rising stock market of the early 1970's, the value of assets and shares in REITs grew rapidly. The asset value of real estate investment trusts rose from $1.0 billion in 1968 to $4.7 billion in 1970, to $14.2 billion in 1972, and to a peak of $20.5 billion in 1974.[26] Significantly, a major element in the explosive growth of the industry was rental housing. The largest single category of investment by the REIT industry as a whole in 1974 was rental housing, with $3.9 billion invested, followed by condominiums, the second largest category, with $3.2 billion invested.[27]

The sharp 1974-75 recession which followed the credit squeeze a year earlier trapped many builder-developers, sponsors, and investors with unfinished buildings, falling demand for speculative properties, and insufficient financing to complete their projects. The result was a severe shake-out of the REITs, particularly the mortgage trusts. The enormity of the debacle can be seen from the fact that more than half the mortgage loans were defaulted and 80 percent of the industry's market value melted away between 1972 and 1975.[28] The total asset value of real estate investment trusts fell from a peak of $20.5 billion in 1974 to $9.7 billion in 1976, to $7.3 billion in 1978, to $7.0 billion in 1980.[29]

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[25] Stephen E. Roulac, Op. Cit., p. 23.

[26] National Association of Real Estate Investment Trusts, Washington, D.C., April 1982.

[27] Alan Rabinowitz, Op. Cit., p. 227.

The impact of the shake-out on shareholders can be seen from the prices and earnings of four major surviving REITS. American Century Investors [30] stock went from a 1971 high of $29.40 to a 1975 low of $.90 while its earnings per share fell from $2.37 to a $7.44 deficit. Enterprise Development Group's[31] stock fell from a 1971 high of $26.40 to a 1975 low of $.60 and its earnings per share fell from $1.92 to a $14.15 deficit. The Thackeray Corporation's[32] stock fell from $22.60 per share to $.50 and its earnings fell from $2.00 to a $4.60 deficit. Transamerica Realty's[33] stock fell from $28.00 to $1.00 and earnings per share fell from $2.21 to a $3.92 deficit.[34]

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[28] The National Association of Real Estate Investment Trusts' stock price index fell from slightly over 100 in 1972 to less than 20 in 1975, Rabinowitz, Op. Cit. p. 217.

[29] Figures on asset values of qualified real estate investment trusts produced by the National Association of Real Estate Investment Trusts, Washington, D.C., April 1982.

[30] Formerly American Century Mortgage Investors.

[31] Formerly CI Mortgage Group.

[32] Formerly Republic Mortgage Investors.

[33] Formerly Mortgage Trust of America.

[34] The Value Line Investment Survey, New York, December 1981.

Losses suffered by the mortgage trusts, their holding companies and the investors in their stock were real and permanent. Funds invested in uncompleted projects could not be recovered. Dividends paid out under the 90 percent payout rule (95 percent since January 1, 1980) to maintain the tax-exempt status of the earnings (to the REITS) had often not been real earnings but a return of capital, diminishing available capital and exacerbating the cash position of the highly leveraged mortgage trusts. Investors lost millions of dollars and, with their money, their confidence in these institutions. The resulting unpopularity of real estate securities is said by industry reporters to continue to have a negative effect on capital accumulation for real estate.[35]

The Real Estate Syndication System for Assisted Housing

This discussion, which provides a frame of reference for how tax incentives relate to the production process, is based on work carried out for the Department of Housing and Urban Development by contractors, discussions with representatives of law firms specializing in real estate syndications, and other sources. To simplify a rather complicated process, the focus is on the major participants. These include builder-developer teams, syndicators, and investors.

Builder-developer teams tend to build expertise and specialize in specific types of activity. For example, teams who work on new subsidized multifamily rental projects would generally not work on market rental housing or rehabilitation projects. A team consists of a group of specialists, functioning in roles such as sponsor, architect, builder, manager, and

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35 *Ibid.*

lawyer. The sponsor usually operates in the central role of project initiator and developer. He selects project sites, deals with government agencies and local officials, prepares and submits development proposals, and serves as team leader. The builder takes responsibility for construction of the project from a set of plans at an agreed-upon cost. There is often a profit and risk sharing arrangement between the builder and sponsor under which the builder contributes to the preconstruction development costs for a share in the project. Other members of the team usually receive fixed fees for services.

A syndicator functions in the role of project wholesaler or marketer, between the builder-developer team and the passive investors. His role is to buy the project from the builder-developer, structure a legal ownership package, most often a limited partnership, and sell the partnership shares to passive investors. He seeks to meet a minimum internal rate of return objective and satisfy the investor's need for tax shelter. A limited partnership, the ownership entity very often used in real estate, is an association of individual investors engaged in transactions for profit, having no legal identity apart from its owners. The limited partners are not liable for any partnership debts over the agreed amount of their investment.

The passive investor is generally an individual seeking a tax shelter to offset income generated from other sources. The Internal Revenue Code (IRC) permits the passive investor, through participation in the limited partnership, to deduct his pro rata share of partnership losses, and requires him to include his pro rata share of partnership gains. The partnership has substantial losses during the construction period, and typically has tax losses during the early years of operation, even though its cash flow may be positive. This results from the depreciation allowances exceeding debt service payments.

The returns that passive investors expect to receive from their partnership participations are often somewhat optimistic. They generally leave to an attorney, accountant or broker the task of critically examining a project's expected rate of return or a developer's skill and reputation. The primary investment criterion to most passive investors is that the tax losses exceed their contributed equity, and thereby shelter income from other sources.

A rental housing development project goes through a complex sequence of steps. The syndication process here described is typical for insured subsidized projects.

The Department of Housing and Urban Development (HUD) solicits applications for Section 8 new construction funding through a Notice of Funds Availability (NOFA) in specific areas of the United States. Some builder--developer teams wait for a NOFA to be issued before committing their time and funds to a potential project. Others will conduct preliminary market analyses, investigate potential sites, and even buy options on sites to be in a position to react quickly to a HUD solicitation. Once a NOFA is issued, a builder-developer team applies to HUD for both a Section 8 rent subsidy allocation and a commitment for mortgage insurance. This begins the application phase.

The next step is for the builder-developer to prepare a description of his proposed project, make estimates of construction and operating costs, and design a management plan. This is submitted to HUD together with a request for a Site Approval and Market Analysis (SAMA). If approved, the builder-developer team and HUD negotiate a detailed agreement on the project specifications and operating plans. Following approval of the project plans at the SAMA stage, the builder-developer team applies to HUD for a firm commitment of mortgage insurance and a Section 8 rent subsidy contract.

At the point of application for firm commitment, the builder-developer team is at considerable risk. If HUD approval cannot be secured, the package would have no value and all pre-construction expenditures would be lost. But once through the firm commitment and Section 8 contract hurdles, the builder-developer has a very valuable package. He is now able to secure commitments from lenders for construction and permanent financing. Once financing commitments are secured, the builder-developer team approaches a syndicator with the project package.

The syndicator conducts a sophisticated analysis of the proposed project, considers the capacity and reputation of the team, and structures a project to insure its viability and profitability to all participants. Using present value and internal rate of return calculations to estimate a proposed project's benefit stream, the syndicator determines a wholesale price for the project that provides an acceptable after-tax return for investors. The syndicator's commission averages about 18 to 22 percent of the equity raised. The passive investors pay the wholesale price and the syndicator's markup, and receive 95 to 99 percent of the project. The developer retains the remaining 1 to 5 percent and usually becomes the general partner of the forthcoming limited partnership.

The syndicator develops an offering of "units of limited partnership interest" in the new entity, which would be for a single project typically containing no less than 30 or 40 housing units and no more than 500 units, with an average of between 100 and 200 housing units. The price paid by investors, expressed as a percentage of the mortgage loan, varies with the quality of the project in terms of risk and rate of return, but is usually about 25 to 35 percent of the project mortgage loan amount.

Because of the high cost and the time required for registering a public offering with the Securities and Exchange Commission, most subsidized rental project are marketed as private placements. Another advantage of private placements, not available in public offerings, is that equity payments can be staged as installments. Even private placements, however, must have state registration, or specific exemption secured from state commissions. In addition, even with exemption, the syndicator is still responsible for providing full disclosure of all relevant project information to potential investors. Notwithstanding the fact that full disclosure requirements are met by practically all issuers, the volume of information provided and the complexity of the material are such that it would be very difficult and time consuming for potential passive investors to assess the quality of a particular offering or to make comparisons among offering.

The investors make their contributions to the partnership in three to five installments. Although there are many variations, an offering may require five annual installments by the limited partners, with the third payment conditioned on substantial completion of the project, the fourth conditioned on final mortgage endorsement, and the fifth upon reaching some agreed-upon level of tenant occupancy. Payments, representing fees and return of capital, are made to the former developer in his new role as general partner of the new business entity.

It is important to note why there are so many individual fees and charges payable to the general partner rather than a single developer fee which includes them all. Under the Tax Code, the developer fee cannot be deducted when paid (expensed) or amortized. It has to be treated as a project cost and be depreciated over the life of the project. Treating the various responsibilities of the general partner separately permits their costs to be written off more quickly and thus increases the rate of return to the investors.

Because of the risks associated with such highly leveraged projects, with their small cash flow margins and token financial commitment by the developer-general partners, it is necessary in most cases for the general partner to provide special assurances in project offerings. These take the form of explicit warranties or guaranties backed by funded reserves. Their value would, of course, vary with the financial strength and reputation of the general partner.

Once a high enough percentage of partnership units have been sold by the syndicator (often utilizing underwriters and broker/dealers), the project may go to initial endorsement (the agreement by HUD to insure the mortgage loan). This is closely followed by the project closing and initiation of the construction period. As construction proceeds, the project draws on its construction loan. As noted above, the limited partners make their payments in stages. The reason for this is to make the investment more attractive. The tax benefits from the project usually approximate the staged payments, thus making it unnecessary for the partners to pay out cash for their interest in the project.

The staging of payments does not affect the project's cash flow. Operating deficits are met through drawdowns on the mortgage proceeds. Sometimes general partners attempt to borrow against the personal loans they made to the limited partners, but this has had only limited success since the notes are contingent and thus not pledgeable.

Upon completion of the construction period, the project begins its operating period, during which it accepts tenants and tries to obtain full occupancy. When an agreed-upon level of occupancy is attained, the project goes to final endorsement of the permanent mortgage loan. This is the last point at which the investors can withdraw from the deal. Typically, they can have their interests repurchased if certain identified conditions are not met, such as the achievement of final endorsement or a stipulated level of project occupancy.

Distribution of Rental Housing Tax Benefits to Investors and Others

In the short run a significant portion of the benefits derived from the rental housing tax provisions of the Internal Revenue Code may not directly accrue to renters. This is particularly true in the case of low-income subsidized rental housing where the rental costs to tenants are a function of other subsidy programs.

An important function of real estate tax incentives is to provide developers and builders of rental property with most of the money they need "up front" to finance new building construction. Tax incentives provide a stream of future tax savings which a builder-developer can sell to outside investors. The money derived from the sale of these tax benefits reimburses a builder-developer for outlays not financed by the mortgage loan and provides him with a profit in return for his entrepreneurship. The cost of construction of the building is primarily paid out of the mortgage proceeds. The commissions and fees to lawyers, accountants and others add costs to the syndication method of financing.

One strong criticism of the syndication approach to raising equity for building construction is that there is significant capital leakage. Only about half of what the tax incentives cost the government in lost revenue actually reaches builders and developers. The remainder goes out in the form of payments to the outside investors for the use of their money, and in fees to the syndicators, lawyers, and accountants who are needed to put together and sell the project package.[36] While such payments and fees may be described as a leakage from the system since they do not directly reduce rents, it must also be considered that in the absence of these costs to facilitate the marshalling of capital, fewer of the syndicated rental housing units now occupied would have been erected.

The value of the tax incentive to the outside investor (or for that matter to the developer or subsequent owners) depends upon the marginal tax bracket of the investor. Because depreciation benefits are write-offs against ordinary income due to the tax status of limited partnerships, their value to the investor is the amount of the write-off multiplied by the marginal tax rate of the investor. Therefore, these tax provisions are most beneficial to the highest tax bracket individuals (70 percent prior to 1981; now 50 percent). As shown in Table 1, 82 percent of the amount of accelerated depreciation deductions for low-income rental housing was taken by taxpayers with adjusted gross incomes greater than $50,000. (Derived from individuals who were subject to the minimum tax. Taxpayers were only subject to the minimum tax if their tax preferences, including accelerated depreciation, were in excess of $10,000.) Since the value to investors of the shares in a project is determined by the marginal tax bracket of the investors, the same investment sold at the same nominal price to all investors would be worth more to those in higher marginal tax brackets than to those in lower tax brackets.

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[36] For more detail, see the Congressional Budget Office Report, Real Estate Tax Shelter Subsidies and Direct Subsidy Alternatives, Superintendent of Documents, U.S. G.P.O., May 1977. The CBO report estimates that 44.5 percent of the tax shelter subsidy goes to the builders-developers, 7.4 percent to the syndicator and 48.1 percent to outside investors.

Table 1

Distribution of Tax Deductions from Accelerated Depreciation in Real Estate from Individuals Subject to the Minimum Tax

	Total		Low income rental housing		Other real property	
	Number of returns	Amount (000)	Number of returns	Amount (000)	Number of returns	Amount (000)
Total...............	88,546	$504,691	7,675	$ 63,549	80,871	$423,820
No adjusted gross income	3,761	50,826	239	5,199	3,522	45,627
$1 under $10,000............	1,235	8,030	114	195	1,121	8,408
$10,000 under $15,000.......	1,513	5,900	4	13	1,509	5,887
$15,000 under $20,000.......	1,760	12,585	615	244	1,145	12,341
$20,000 under $30,000.......	7,717	26,990	99	861	7,618	26,129
$30,000 under $50,000.......	14,293	47,599	833	4,909	13,460	42,690
$50,000 under $100,000......	24,456	84,243	2,072	14,241	22,384	70,002
$100,000 under $200,000.....	21,850	122,878	2,427	20,517	19,423	102,361
$200,000 under $500,000.....	9,598	79,513	1,009	11,055	8,589	68,458
$500,000 under $1,000,000..	1,761	30,909	190	3,541	1,571	27,368
$1,000,000 or more..........	602	17,404	73	2,774	529	14,630

Source: U.S. Internal Revenue Service, Statistics of Income, 1978, Individual Income Tax Returns, 1981. Table 3.8, p. 97.

This difference has been sharply curtailed by the 1981 Economic Recovery Tax Act (ERTA), which reduced the top marginal tax bracket from 70 percent to 50 percent. However, the net effect of ERTA appears to have been to increase the price to investors of subsidized housing projects, which adjust quickly to changes in the Tax Code and program regulations. The downward pressure on project prices resulting from the reduction in maximum tax brackets to 50 percent was more than made up by the upward pressure on project prices resulting from the more rapid capital recovery permitted under ERTA.[37]

As payment for the accelerated depreciation and other tax benefits derived from ownership of a syndicated Federally assisted rental housing project, investors pay between 25 and 35 percent of the project's mortgage loan. Experience with low-income multifamily housing programs indicates such a range, with the higher end seen in the most well-located elderly projects and the lower end seen in less well-located family projects.[38] The net cash proceeds from the sale of a project to the passive investors are reduced to allow for marketing, profit, fees and other expenses. As indicated above, a Federally assisted rental housing project is packaged by a builder-developer team and sold to a syndicator. The difference between the cost of the total package to the builder-developer team and the amount paid for 95 to 99 percent of the project by the syndicator represents the developer fee and, together with the remaining 1 to 5 percent of the project, is the builder-developer team's compensation for a substantial amount of work and risk. The developer fee, net of private development funds, is generally about 9 or 10 percent of the mortgage loan amount, depending on the expected profitability of the project. If a broker-dealer is involved in the marketing of the project, it would cost about 2 percent of the mortgage loan amount.

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[37] David A. Smith, The Investor Quarterly, Boston Financial Technology Group, Inc., Vol. 3, Number 3: Second Quarter 1981. (Follow-up discussions were conducted with Mr. Smith in October 1982)

[38] Congressional Budget Office, Op. Cit. and discussions with developers and syndicators.

While the developer would appear to contribute cash for the 10 percent of project cost not covered by the mortgage loan (in the case of a 90 percent loan), this amount is largely offset by the inclusion of an Allowance for Builders and Sponsors Profit and Risk (BSPR) in the mortgage loan. BSPR applies to subsidized housing projects where there is a community of interest between the developer and builder, as is very often the case. The effect of the BSPR allowance is to make the mortgage into a 100 percent loan.

"Up-Front" Costs

"Up-front" costs are usually defined as the initial expenses, not including direct construction expenditures, incurred in real estate projects prior to the time rental operations begin.[39] These costs are also called "start-up costs" or "pre-opening expenses." In general, such costs can be classified into three categories. These are (1) currently deductible when paid or incurred, (2) amortized or depreciated, and (3) capitalized and non-deductible. A deductible cost, whether deductible immediately or over a stipulated period, is one which has the effect of reducing the project's taxable income or increasing its loss. An amortizable or depreciable cost is one which may be deducted over a period of time. A depreciable cost may be taken on an accelerated basis but an amortizable cost must be taken on a straight-line basis. Certain "up-front" costs are applicable only to HUD assisted rental projects, while others are applicable to rental housing projects generally.

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[39] This discussion is based in part on research carried out for HUD by the law firm of Tucker, Flyer, Sanger, Reider and Lewis during 1981.

Within the first category (HUD assisted) are costs associated with FHA examination and inspection, mortgage insurance premiums, FNMA/GNMA commitment fees, FHA financing fees, permanent financing discounts, and construction period interest and real estate taxes. FHA examination and inspection fees are charged by HUD for examination of a developer's insurance application and inspection of the construction of the project. These costs are capitalized into the cost of construction and depreciated accordingly. The examination fee is .3 percent and the inspection fee is .5 percent of the mortgage loan.

Insurance premiums in connection with the construction of a project are treated as a cost of construction. Premiums in connection with the financing of construction are deductible during the construction period. The FHA mortgage insurance premium is .5 percent of the mortgage loan. FNMA/GNMA commitment fees, equal to 2.0 percent of the mortgage loan, are now treated by the IRS as a cost of acquiring a loan, thereby requiring that such a cost be deducted over the life of the construction loan and/or permanent loan.

The FHA mortgage fee is amortizable over the life of the combined loan. The FHA financing fee is equal to 1.5 percent of the mortgage loan. When the permanent financing is obtained through GNMA, the financing charge (or discount) actually represents prepaid interest. This cost, usually 2.5 percent of the mortgage loan, is withheld from the permanent loan by GNMA and must be amortized over the life of the loan.

Construction period interest and local property taxes are costs incurred during project construction. For HUD assisted low-income rental projects, these costs may be deducted when they are paid (expensed). For unassisted rental housing, these costs must be amortized over a 10 year period. Construction period interest and property taxes are a function of interest rates, local property tax rates, and the length of the construction period.

Other "up-front" costs not specifically related to HUD assisted rental projects include title fees, insurance premiums, transfer and recording taxes, legal and accounting fees, and general partner fees. Title fees must be capitalized and depreciated over the useful life of the project while transfer and recording taxes are deductible when paid or incurred.

These two costs total between 1 and 2 percent of the mortgage loan. Legal and accounting fees are broken down into several parts. One part relates to construction and must be depreciated with the building. Another part relates to fees for examining contracts, settling accident claims, and reviewing loan documents and must be capitalized. A third part represents tax advice and is deductible when paid or incurred. A fourth part represents organizational expenses and may be amortized over a 60 month period. Legal and accounting fees total between $10,000 and $30,000, and often more depending on the size and complexity of the project.

The fees and costs identified above are paid to persons or entities outside the partnership. Another type of cost is incurred "up-front" which is paid to the general partner of the syndicated limited partnership for certain services he performs and risks to which he is exposed. As described above in the discussion of the syndication process, as passive investors make their installment contributions to the partnership, the developer shifts to a new role as general partner of the new entity.

The general partner receives, from the installment contributions by the passive investors, a construction loan guarantee fee for personally guaranteeing to arrange funds to complete construction and a construction loan brokerage fee for obtaining the construction loan. Both of these fees are capitalized and amortized over the construction loan period.[40] The general partner receives a standby lender commitment fee to compensate him for guaranteeing that permanent financing will be available if the agreed-upon mortgage lender fails to make the loan. This fee is fully deductible when paid.

The general partner receives a rent-up fee for arranging the initial renting of the apartment house. For tax purposes this fee is amortizable over the life of the leases obtained -- usually one year. A no-negative-cash-flow guarantee fee is often received by the general partner to compensate him for making such a guarantee to the limited partners. Similar to an insurance premium, this cost is amortized over the period for which it is effective. Where excess cash reserves are anticipated, a fee for investment advisory services is sometimes paid to an affiliate of the general partner or a third party. This fee is deductible over the period that the services are expected to be provided.

Another insurance-type of fee, limited to some HUD assisted rental projects, is compensation to the general partner for agreeing to repurchase the limited partners' shares within the first few years of the partnership if the project is not completed on time. While this fee would appear to be deductible for the period of the purchase agreement, there are legal problems surrounding this fee.[4]

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[40] The tax treatment of these two fees is not entirely clear because of legal problems associated with the one loan-two loan issue. See Blitzer v. United States (U.S. Ct. Cl. No 426-76) and Rev. Rul. 74-395 and 75-172. Industry practice has been to amortize the applicable fees and costs with the construction loan in anticipation of a favorable legal interpretation that there are indeed two loans.

The general partner receives a fee for executing a covenant not to compete with the limited partnership by building, leasing, or managing a similar property for a given period of time and within a certain distance from the project. The fee for such a covenant is capitalized and depreciated over the life of the project. Finally, there is the management fee for operating and managing the property and running the partnership. In many cases there is also an incentive management fee, computed as a percentage of cash flow above original projections, which includes penalties for poor performance. The amount of the management fee varies and is subject to market conditions.

The up-front fees and charges for services of various kinds by accountants, lawyers, syndicators, brokers, managers and others represent roughly 12 to 13 percent of the mortgage loan amount. These costs are deducted at the outset of the project from the equity contributed by the limited partners or from personal loans to the project from the general partner on behalf of the limited partners. As such, they do not directly benefit a project. While it may appear that the front-end fees and charges

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[41] There is a question as to whether true ownership of the project really exists for the limited partners if such ownership is constructively contingent on events such as timely completion of the project. Rev. Rul. 78-411, 1978-2 C.B. 112.

here described, together with the investor tax deductions, increase the costs of the housing units produced without adding anything tangible to their construction, the reality is that these outlays are a necessary part of the production process for subsidized housing. The costs are incurred to buy the expert services critical to a successful project. Under the existing production process outside investors represent the only viable source of equity capital to defray the front-end costs and initiate a subsidized housing project.

Current Directions

Several years have passed since the painful losses in syndicated partnerships and real estate investment trusts. Many of the excesses of the early 1970's have been corrected. The equity trusts have shown themselves able to survive and grow; the remaining mortgage trusts have improved their practices and substantially reduced their leverage. For example, looking at the same four REITs discussed above, American Century Investment reduced its debt to equity ratio from 1.8 to 1 in 1973 to .7 to 1 in 1981. Enterprise Development Group reduced its debt to equity ratio from 2.3 to 1 in 1973 to less than .1 to 1 in 1981. Similarly, Thackeray Corporation and Transamerica Realty reduced their debt to equity ratios over the same period from 1.3 to 1 to .4 to 1 and from 1.4 to 1 to .1 to 1 respectively.[42]

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[42] Ibid.

Other factors are coming into play to provide hopeful signs for the rental housing industry. Fewer apartments are remaining vacant. The vacancy rate for 1981 was 5.0 percent, compared with 5.4 percent in 1970 and 8.0 percent in 1960.[43] In addition, rents have increased lately almost as rapidly as inflation. In 1981, the rent component of the Consumer Price Index rose by 8.5 percent while the overall Index rose 8.9 percent. Industry sources believe that rent increases in professionally managed units almost certainly rose higher than the Consumer Price Index did.[44] And as another sign of an improving real estate investment climate, Merill Lynch is acquiring real estate firms again, purchasing Johnson and Johnson Realty in Florida and Harleigh Sandler in California.[45]

For the first time since the severe 1973-74 shakeout made the real estate investment trusts exceedingly unpopular among investors, early signs of interest are now beginning to be seen. Analysis of 13D Acquisition Reports[46] filed with the Securities and Exchange Commission as of the end of November 1981 show a significant increase in large block holding of REITs. There was a total of 215 large block holdings reported for the first 11 months of 1981, each representing at least 5 percent of a REIT'S total equity capitalization, with an 11 month total value of $1.5 billion compared with $.5 billion for all of 1980.[47]

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[43] Current Housing Report H-111, "Housing Vacancies," Bureau of the Census, U.S. Department of Commerce.

[44] Housing, March 1982, p. 12.

[45] Ibid.

[46] Sec. 13D Acquisition Reports must be filed with the Securities and Exchange Commission within 10 days from the time an entity acquires 5 percent or more equity ownership of a corporation.

There are three reasons for renewed interest in the REITs by sophisticated investors. First, as indicated above, they have significantly improved their business practices. Not only have they reduced their debt to equity ratios, but they have disposed of their problem properties, taken the necessary write-offs, and reduced non-earning assets to negligible levels. Second, their earnings have held up well and, of course, so have their dividends (to remain tax-exempt, REITs must distribute 95 percent of earnings). Third, REITs are still carrying most of their holdings at valuations of several years ago, when many trusts were obliged to foreclose on bankrupt builders. Therefore, REIT stock values often reflect hardship real estate property valuations. In other words, many REITs trade at 30 to 40 percent below current appraised values of their portfolios.[48] Possible harbingers of improvement may be seen in Citibank's Real Estate Stock Fund established in 1980 and already grown to an asset value of $90 million, of which 35 percent have been invested in the discounted REITS. In addition, Lomas & Nettleton, a spin-off of Lomas & Nettleton Financial, the largest U.S. Mortgage banker, was able to raise $50 million in a public offering in 1981. Lomas & Nettleton specializes in apartment projects.[49]

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[47] Michael Brody, "REITS at a Discount", Barrons, March 1, 1982.

[48] Ibid.

In what may be a significant sign of renewed interest in rental housing investment, one of the largest apartment syndicators, Consolidated Capital Corporation, recently brought 47 buildings to the market with a total asking price of approximately $400 million. Buyers were expected to be small private placement limited partnerships. Under current market conditions, transactions for such properties take place with up to 30 percent down, payable over 2 or 3 years. Variable rate mortgages are negotiated with below market interest rates for 5 to 7 years, sometimes up to 10 years, depending on the amount of up-front cash.[50]

Another interesting development is the work now going on to develop a secondary market in limited partnership shares, an innovative response by a number of real estate syndicators, developers and investment bankers to the lack of liquidity of real estate partnership shares. One of the effects of the long sustained period of high mortgage interest rates on real estate markets has been a virtual inability by many sellers to implement transactions without taking part in the financing. As a result it has become very difficult to finance multifamily housing developments even through the use of public syndications. Many investors remain locked in their partnership participations even when the underlying properties have been sold. For example, to implement the sale of a housing development, it has become necessary to take back long-term paper (12-15 years) for any sale proceeds above the amount needed to pay off the short-term debt. This phenomenon has resulted in two problems. First, it has prevented investors from recovering their funds from existing conventional housing partnerships and re-investing in new developments.[51] Second, the liquidity problem has probably discouraged many potential investors from participating in rental housing developments altogether.

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[49] Ibid.

[50] James P. Meagher, "Yields and Terms on Apartments," Barrons, May 3, 1982.

A secondary market is being developed by three firms: Rexmoor Properties, Inc.; Hotel Properties of America, Inc.; and Consolidated Properties, Inc. While Hotel Properties specializes in lodging facilities, the other two firms seek a variety of real estate. Their objective is to assemble diversified real estate portfolios by offering their stock for partnership units, thus providing a market for shares in real estate limited partnerships. This process will enable holders of partnership shares to trade all or part of their otherwise illiquid holdings for stock in these real estate companies.[52]

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[51] Based in part on discussions with Basil P. Rallis, Vice President of Preferred Financial Corporation and several other developers and syndicators in April 1982.

[52] John B. Levy, "Where's the Equity?," Barron's, March 22, 1982 and James P. Meagher, "The ground Floor," Barron's, November 1, 1982.

An important advantage of such a secondary market to its participants is that exchanges can take place without adverse tax consequences since, under certain circumstances, trading property for stock may be considered a tax-free exchange.[53]

An attempt in early 1982 to create a secondary market for real estate partnership holdings, while on a much smaller scale than the present plan, has apparently been successful. First Capital had sponsored three real estate partnerships during the period 1978-1980 that were supposed to dissolve within 5 to 7 years. When market conditions made dissolution unwise, First Capital developed an exchange device whereby limited partners exchanged their holdings for corporate stock. Wall Street investment banking firms such as Merrill Lynch and others appear to be showing some interest in utilizing a secondary real estate market in relation to the large conventional public limited partnerships developed by such major syndicators as JMB, McNeil, and Fox and Carskadon.[54]

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[53] Internal Revenue Code, Sec. 351.

[54] John B. Levy, Op. Cit.

B. Federal Tax Incentives and Rental Housing

Introduction

This section provides a frame of reference for how tax incentives affect the rental housing production process. It focuses on the specific provisions of the Federal Tax Code that impact on real estate investors and affect their decisions in the market. It discusses Federal tax incentives for rental housing and non-residential buildings.
In addition, it summarizes the real estate investment provisions of the Economic Recovery Tax Act of 1981 (ERTA), identifies the major differences between ERTA and the previous law in regard to investment in rental housing, and considers the likely effects of such changes on rental housing.

Rental assistance, attractive financing, and Federal tax benefits represent three broad subsidy areas for housing. Low-income rental housing is subsidized by HUD through a number of programmatic and financing devices. Under the Section 8 program, HUD makes up the difference between the fair market rent for a housing unit and up to 30 percent of a qualified tenant's adjusted income. A second set of subsidies takes the form of attractive construction and permanent financing arrangements, and a third set represents Federal tax incentives or subsidies to investors. The cost of this latter set of subsidies is borne by the Treasury in the form of tax revenues forgone.

The reason for Federal tax subsidies for low-income rental housing is the perception that the first and second types of subsidies (rental and financing) are not large enough to get much new low-income housing built. Market uncertainties, the burdens of HUD processing, development risks, HUD's restrictions on the rate of return, low operating cash flow, and little likelihood of capital gain, make such housing a relatively unattractive investment without some additional inducements. The Federal tax incentives discussed in this report represent the additional inducements needed to attract investment capital into low-income rental housing.

Federal tax incentives accomplish the task of attracting investment capital into low-income rental housing by enabling developers to obtain their equity capital through the sale of the tax benefits in a project. For this system to operate, it is necessary that the value of the tax subsidy be large enough to provide sufficient tax benefits to passive investors, adequate profit to developers and syndicators, and the fees and commissions needed for an array of lawyers, accountants, broker-dealers, and investment advisors. The subsidized low-income housing development process, including the interaction of the various participants, has been described in the previous section of this report.

Conceptually, an income tax is a "net income" tax; that is, it permits a taxpayer to subtract from his gross income any legitimate costs associated with earning that income. One such cost in the ownership of rental housing is the "using up" of capital through the wear and tear and obsolescence of the building. Tax deductions, ostensibly to reflect the "using up" of capital, are available to the investor. Tax deductions, however, take the form of tax subsidies when they do not reflect the economic reality of reduction in value of capital, but rather, reflect a conscious decision by government to give special benefits to those investors who can be induced to invest in low-income rental housing. A tax incentive or subsidy is considered a tax shelter when it allows a taxpayer to obtain non-economic, artificial losses that can be applied as offsets, not only against the income from the investment providing such losses, but also against a taxpayer's other income as well.

There are several characteristic features that are generally present in a real estate tax shelter investment. One is the deferral of tax liability on current income, resulting from an acceleration of deductions in the early years of an investment. This has the effect of postponing a present tax liability until a future date, and constructively provides the advantage of an interest-free loan from the government. Another feature, related to deferral, is the conversion of ordinary income to capital gains upon the sale of the project. Conversion occurs when that part of the gain on the sale of a project representing accelerated deductions taken earlier as losses against ordinary income, is later taxed at the more favorable capital gains rate. A third feature is leverage. A tax shelter investor can maximize his tax benefits by using borrowed funds to finance a large portion of the cost of a project, against which accelerated deductions are taken. A fourth feature, the *limited partnership*, is the business form that permits an investor to limit his investment risk to his contributed equity (as in a corporation) and still have the benefit of deducting business losses (as in a partnership) when filing his personal tax return.[55]

Table 2 is presented to place in perspective the relative sizes of the Federal tax subsidies available to rental housing. Out of the total of $34.4 billion in Federal tax subsidies for housing estimated by the Treasury for calendar year 1981, $0.2 billion is directly related to rental housing. This includes the 5 year write-off of rehabilitation expenditures and the deduction of construction period interest and property taxes. Some portion of the $1.2 billion exclusion of interest on state and local housing bonds is attributable to rental housing, but data are not available on how much it is. In addition, the revenue loss estimate for accelerated depreciation on rental housing is no longer included in the tax expenditure budget.[56] However, as seen in Table 2, by far the lion's share of the Federal tax subsidies relate to owner-occupied housing.

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[55] The characteristic features of a tax shelter investment are discussed more fully in *Overview of Tax Shelters*, Joint Committee on Internal Revenue Taxation, Washington, D.C., 1975.

[56] Before ACRS there was a special provision for accelerated depreciation on rental housing. The subsidy cost for accelerated depreciation on rental housing was estimated to be approximately $1.0 billion in calendar year 1980. The ACRS provisions now constitute general income tax rules for determining how the cost of depreciable assets are recovered. Therefore, the ACRS provisions are general rules and accelerated depreciation is no longer treated as a tax subsidy for the tax expenditure budget.

Table 2

Estimated Federal Tax Subsidies for Housing
Calendar Year 1981
(in billions)

Federal Tax Subsidy	Amount
Homeowners deduction of mortgage interest and real estate taxes	$30.6
Deferral or non-recognition of capital gains on sale of owner-occupied housing	2.2
Accelerated depreciation on rental housing	a
Five-year write-off of rehabilitation expenditures on low-income rental housing	b
Deduction of construction period interest and property taxes	0.2
Excess bad debt reserve deductions by thrift institutions	0.2
Exclusion of interest on state and local housing bonds	1.2
Exclusion of interest on all-savers certificates	b
Total	$34.4

Source: U.S. Treasury, Office of Tax Analysis.

a. Accelerated depreciation for rental housing is no longer calculated for the tax expenditure budget as a result of the changes in the 1981 legislation. (Special Analysis G, U.S. Budget, FY 1983, pp. 6-7).

b. Less than $0.05 billion.

Federal Tax Provisions Applicable to Rental Housing Investment

Some Tax Code provisions serve as incentives for real estate investment, while others serve as offsets to such incentives and operate to limit their available benefits. Some provisions focus on individual investors, others on institutions, and still others on public and quasi-public agencies. The discussion below describes the major Federal tax provisions applicable to rental housing investment.

The section on depreciation, recapture, and capital gains describes accelerated depreciation, a major tax incentive available to real estate investors, and its offset, recapture. In addition, the relationship is described between accelerated depreciation and capital gains. This is followed by a discussion of the limited partnership, the type of business organization that has proved invaluable to real estate investment. It also describes the special advantages to real estate investors of the inclusion of non-recourse debt in depreciable base. Next is a description of another of the major real estate investment tax incentives, the expensing of construction period interest and property taxes. The effects of the 1976 Tax Reform Act and the Economic Recovery Tax Act of 1981 on this tax incentive are indicated for various classes of real estate.

The section on the minimum tax on tax preferences and the maximum tax contains a description of this important but rather complicated offset to many of the tax incentives. This is followed by a discussion of the excess bad debt reserve, a tax incentive to financial institutions to maintain investment portfolios favoring mortgage loans and other desired investments.

The section on tax-exempt financing describes the interest subsidy available to state housing finance and development agencies and public housing authorities and their instrumentalities. The discussion of historical versus replacement costs provides another dimension to the contention that the value to investors of the accelerated depreciation subsidy is being significantly impaired by inflation.

(1) Depreciation, Recapture, and Capital Gains

Depreciation is an accounting device for deducting from taxable income the cost of an asset over a period of time which corresponds to its estimated useful life. Its purpose is to enable a business to recover its capital investment in an asset and avoid having such recovery of capital taxed as income. The useful life of an asset for depreciation purposes should conform to the actual wear and tear or obsolescence of the asset. A tax subsidy results from depreciation where the tax laws and regulations permit the useful life of an asset to be shorter than its economic life, salvage value to be underestimated or ignored, and the bulk of depreciation deductions to be taken in the early years of an asset's life.

The tax advantage of depreciation is considerably enhanced for investors to the extent that it can be converted to capital gains income, which is accorded favorable tax treatment. Under the Internal Revenue Code (IRC), the amount of net capital gains deductible by a taxpayer upon the sale of an asset is 60 percent. Although the remaining 40 percent of net capital gains could be taxed at a maximum rate of

50 percent, the effective maximum rate on the total gain is 20 percent (40% x 50% = 20%). The term "net capital gain" means the excess of the net long-term capital gain for the taxable year less the net short-term capital loss for the year (IRC Sec. 1222 and 1231). A taxpayer can obtain large tax savings by taking depreciation deductions against ordinary income, which may be taxable at up to a 50 percent marginal rate, and then paying tax at lower capital gains rates when the depreciated asset is sold. Through the devices of depreciation and capital gains, the IRC permits a taxpayer, in effect, to convert ordinary income to capital gains income for tax purposes.

In an attempt to limit somewhat the substantial tax benefits accorded to investors by depreciation and capital gains, the concept of recapture of previously deducted depreciation was introduced into the IRC. It was applied initially to machinery and equipment (IRC Section 1245) in 1962 and to real estate (IRC Section 1250) in 1964. Under the full recapture provisions applicable to machinery and equipment, that portion of the gain on the sale of an asset which is equal to the total of depreciation deductions previously taken, is taxed as ordinary income rather than as capital gains. However, even full recapture represents a tax subsidy since the taxpayer has the benefit of what, in effect, is an interest free loan from the government from the time the deductions are taken to the time of subsequent sale and recapture.

Prior to the Economic Recovery Tax Act of 1981 special tax benefits were available to the real estate industry, particularly housing, that were not generally available elsewhere. Under the 1981 Act, the real estate and housing depreciation provisions were substantially liberalized, as described below, and investments in such assets continue to retain some advantages over investments in other assets, but their relative advantage has been reduced. (See pages 59-65 for a more detailed discussion of the Act).

Before the 1981 Act, owners could take depreciation on new residential buildings using double declining balance or sum of the years digits. Owners of used residential buildings could take 125 percent declining balance. Tax useful lives for new apartment houses, while officially listed as 40 years, could often go as low as 30 to 35 years without IRS challenge. It was also possible to depreciate the various components of buildings separately, and thereby produce a lower average tax useful life. These provisions were in contrast to the treatment of new non-residential buildings, on which depreciation was limited to 150 percent declining balance, with tax useful lives of 45 years for office buildings, 50 years for banks, and 60 years for warehouses.[57] Depreciation on used non-residential buildings was limited to straight line.

Under the 1981 Act, which makes no distinction between new and used buildings, owners of residential as well as non-residential buildings may take 175 percent declining balance depreciation. This replaces the 200 percent and 125 percent declining balance methods previously available to new and used residential buildings respectively, and 150 percent declining balance and straight line methods for new and used non-residential buildings respectively. Owners of low-income housing, however, may continue to take 200 percent declining balance depreciation. The tax useful lives of buildings were changed dramatically by the 1981 Act. For all buildings, tax useful lives have been reduced to 15 years. Owners also have the option to elect to use straight line depreciation over 15, 35, or 45 year periods.

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[57] Guideline Lives for Certain Buildings, Rev. Proc. 62-21, 1962-2, C.B. 418.

The recapture provisions have been changed in an important way. Non-residential buildings are treated less favorably under the 1981 Act than residential buildings. Prior to the 1981 Act, for both residential and non-residential buildings, only the amount of the gain on sale which was equal to the depreciation deducted in excess of what would have been deducted under straight line depreciation (excess depreciation) was subject to recapture as ordinary income. This provision remains for residential buildings, but has been changed for non-residential buildings. Non-residential buildings will be treated in a manner similar to other types of assets such as machinery and equipment, i.e., any gains on sale which are equal to depreciation deductions previously taken will be fully recaptured as ordinary income. Recapture applies only when accelerated depreciation is taken or when any depreciation is taken on property held for less than one year.

Retained in the 1981 Act is an especially attractive tax benefit available to investors in low-income rental housing. As indicated above, depreciation for low-income rental housing is allowed the 200 percent declining balance method. As with other rental housing property held for one year or more, recapture is limited to excess depreciation only. However, there is a special provision for phase-out of recapture liability that is only available for low-income rental housing. This provision allows a reduction of the recapture liability after the property has been held for 100 months. The reduction is 1 percent for each month the property is held after the initial 100 months. This results in the total elimination of recapture liability at the end of 180 months.[58] The phase-out provision had been even more favorable prior to the Tax Reform Act of 1976 (TRA), permitting a phase-out of 1 percent per month to commence after only 20 months.

An especially rapid form of depreciation is available for investment in housing rehabilitation. Section 167(k) was added to the IRC by the Tax Reform Act of 1969 for the purpose of encouraging private owners and investors to rehabilitate housing for low-income families. This section allows a taxpayer to amortize rehabilitation expenditures over a 60 month period on a straight line basis.

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[58] Total elimination of recapture liability is 180 months under the Economic Recovery Tax Act of 1981 instead of 200 months as it would appear to be under the phase-out formula. This is the case because full capital recovery is now achieved in 180 months and there is no remaining excess depreciation. See Sec. 1250(a)(1)(B)(i) of the IRC.

There are certain restrictions to this tax subsidy. There must be a minimum expenditure for rehabilitation over a consecutive 2 year period of at least $3,000 per unit, and the total amount of rehabilitation expenditures to be depreciated over the 60 month period may not ordinarily exceed $20,000 per unit. In addition, the Internal Revenue Service has strictly enforced a rule requiring submission of notarized income certifications from the tenants and detailed supporting data along with investors' tax returns. Recapture of excess depreciation and recapture phase-out are also applicable to Section 167(k).

The 1981 Act has increased the amount of expenditures eligible for amortization to $40,000 per unit, but only under special circumstances. The increased amount would be applicable only if the rehabilitation work is carried out in accordance with a program certified by HUD or by a state or local governmental unit, under which the tenants may purchase their units at a limited profit to the seller, and the tenants occupy the units as their principal residences.

(2) Limited Partnership, Non-Recourse Debt, and Leverage

The limited partnership form of business organization is, of course, available to investors in other industries. However, it has proved to be especially valuable to the real estate industry. Unlike the general partnership, in which all the partners in a business have unlimited personal liability, in a limited partnership there is no liability for the debts of the business beyond the value of the limited partner's investment. There must be a general partner with unlimited liability who manages the partnership. In some cases the general partner may be a corporation. Despite the limited partnership's resemblance to a corporation, the IRS treats it as a partnership for tax purposes. As a result, there is no tax levied on the partnership itself, and business (accounting) losses, typical of real estate projects in their early years, are carried through to the individual partners. The partners, in turn, take the losses as deductions on their individual tax returns.

The use of non-recourse debt (non-recourse against the investor) in the basis for depreciation gives a major advantage to real estate investment in comparison with other investments subject to the "at risk" limitations of the Code. Under the present IRC rules, real estate is the only type of investment still permitted to take advantage of non-recourse debt in this way. Real estate is generally highly leveraged with mortgage debt for which the collateral is the property itself. However, the tax basis for depreciation purposes is the total cost of the building irrespective of the amount actually at risk. Therefore, even though an investor has incurred no personal liability for the debt, which may be equal to 10 or more times the cash equity in the property, he is permitted to take depreciation deductions on the total depreciable base of the property.

(3) Construction Period Interest and Property Taxes

Expenditures associated with the construction of a real estate project are generally treated as part of the cost of the project and capitalized. Most of these expenditures are recovered by the investor through depreciation deductions on the building over its useful life. Some, however, are recoverable only upon sale or exchange of the project (e.g., syndication fees) or through amortization over a specified period (see IRC Section 709). A significant exception occurs, however, with respect to expenditures made during the construction period for interest and property taxes. Under the IRC, the cost of construction period interest and property taxes can be taken as deductions during a much shorter period than the useful life of the building. Amortization for construction period interest and property taxes was set in 1976 under the TRA at 4 years for commercial buildings. This increased by one year each year until it reached 10 years in 1982. For rental housing the amortization period began as 4 years in 1978 and will similarly increase each year until it reaches 10 years in 1984. For subsidized rental housing, the amortization period was scheduled to begin at 4 years in 1982 and increase each year until it reached 10 years in 1988. However, the Economic Recovery Tax Act of 1981 repealed the requirement for amortization of construction period interest and property taxes for low-income housing. Therefore, owners of low-income housing will continue to be permitted to deduct their expenditures for construction period interest and property taxes as expense items.

While the phasing-in of 10 year amortization, introduced in the 1976 TRA and continued in the 1981 Economic Recovery Tax Act, except for low income housing, represents a significant cutback from the earlier rules that such expenditures could be totally deducted during the construction period, this provision still remains a major tax benefit available to investors. The value of this special tax treatment for construction period interest and property taxes is enhanced by the industry practice of folding the cost of these deductions into the permanent nonrecourse financing of a project. As a result, a large deduction is provided to the investor without the need for any additional equity investment.

(4) Minimum Tax on Tax Preferences and the Maximum Tax

Tax preference items are certain income tax deductions which benefit higher bracket, tax shelter oriented taxpayers. Such deductions comprise artificial (non-cash) expenditures, such as excess depreciation. The minimum tax reflects an effort to impose additional tax liability on such higher bracket, tax shelter oriented taxpayers who have benefited from tax preference items. As a result, minimum tax provisions on tax preferences often act as negative tax subsidies, that is, as offsets to other tax subsidies. Items of tax preference are subject to the minimum tax, now set at 15 percent of the amount by which tax preference items exceed the greater of $10,000 or one half of the tax otherwise due (without the deductions resulting in the tax preferences).

The minimum tax provisions are applicable in the same way to investments in commercial, market residential, and low-income rental housing. Prior to the 1976 TRA, there was a minimum tax of 10 percent on tax preference items over $30,000. Tax preference items included the untaxed portion of long-term capital gains and excess depreciation.

This provision was changed by the 1976 TRA to a 15 percent tax on tax preference items totaling over $10,000, and the category of excess itemized deductions was added as a tax preference item. The minimum tax provision was changed again by the 1978 Revenue Act, under which untaxed capital gains and excess itemized deductions were eliminated from the minimum tax. The minimum tax is essentially the same under the 1981 Act.

Prior to the 1976 TRA, the maximum tax limited the tax on personal service income to 50 percent. However, tax preference income in excess of $30,000 reduced the amount of earned income qualifying for the benefits of the 50 percent maximum tax. The 1976 TRA removed the $30,000 floor, permitting tax preference items to reduce dollar-for-dollar the amount of personal service income available for the maximum tax. The 1978 Revenue Act liberalized the maximum tax somewhat by removing untaxed capital gains as a tax preference item. The 1981 Act significantly liberalized the 50 percent maximum tax by repealing the special provision relating tax preferences to personal service income, and by applying the maximum tax to income from all sources.

(5) Excess Bad Debt Reserves

A tax subsidy is provided to financial institutions which invest specified portions of their portfolios in qualifying assets.[59] The IRC allows such institutions to take artificially high bad debt reserves, thus reducing their Federal taxable income. The bad debt reserves that may be taken instead of reserves related to actual loss experience or anticipated losses, range up to 40 percent of qualifying assets. A sliding scale of percent of reserve to percent of qualifying assets goes up to a maximum of 40 percent reserves for 82 percent qualifying assets.[60]

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[59] Qualifying assets include residential real estate loans; cash; U.S. Government obligations; loans secured by members' deposits; loans secured by church, school, health and welfare facilities, or commercial property located in an urban renewal or model cities area; student loans; and property used in the conduct of the institution's business.

The minimum tax on tax preferences functions as an offset to the excess bad debt subsidy. A financial institution is required to make a comparison each year between the arbitrary bad debt reserve taken and its actual loss experience, the difference being a tax preference item. After computing its basic tax return, the financial institution must then calculate its additional tax liability resulting from the minimum tax on all its tax preferences, one of which is the excess bad debt reserve. A tax liability of 15 percent is incurred on the amount by which the total tax preferences exceed the greater of $10,000 or the taxes otherwise due (which have been reduced by the deductions resulting from the tax preferences). The Economic Recovery Tax Act of 1981 retains the special bad debt rules for financial institutions.

(6) Tax-Exempt Financing for Rental Housing

Tax-exempt financing has become a major subsidy in recent years for the development of multifamily rental housing. While the numbers and type of public agencies and public agency designates have grown within the last several years, the most important borrowers of tax-exempt funds for housing purposes are state Housing Finance and Development agencies (HFDA's). These agencies, which used tax-exempt borrowing initially to support the development of subsidized rental housing, have branched out into middle income and single family housing. HFDA's borrow funds in the tax-exempt market through the issuance of long-term bonds which are exempt from Federal taxation under Section 103 of the IRC. HFDA bonds are secured by pools of several projects. Because such borrowings are tax-exempt, their rates of interest are below those for comparable taxable borrowings. The subsidy to housing comes from the reduced cost of the money raised through the tax exemption.

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[60] These figures apply to savings and loan or cooperative institutions. Mutual savings banks would qualify for the maximum bad debt reserve deductions when 72 percent of their assets are invested in qualified assets.

There are four major approaches that utilize the lower cost money raised through tax-exempt borrowing by HFDA's. These are: (1) relending the funds at below market rates for housing construction; (2) providing mortgage subsidies for purchasers of housing; (3) providing loans with below market interest rates to thrift institutions for relending to purchasers and developers of housing; and (4) purchasing in the secondary market, loans with below market interest rates which were originated by thrift institutions.

In sections of the United States without HFDA's or with HFDA's having limited capacity, there was a need for another vehicle to provide tax-exempt financing for low-income rental housing. That vehicle, which has since spread throughout the country, is provided by Section 11(b) of the United States Housing Act of 1937 (USHA). This Act permits tax-exempt financing for lower-income housing (100% Section 8) projects irrespective of whether the sponsors are profit motiviated or nonprofit or whether the projects are insured or uninsured. The tax-exempt bonds may be sold as public offerings or private placements. Unlike HFDA offerings, a Section 11(b) bond issue is secured by a single project and the pledge of Section 8 contracts. To qualify for the tax exemption, the issuer of Section 11(b) bonds must be a local housing authority or its agency or instrumentality. The instrumentality is generally a nonprofit corporation created by the local housing authority for the sole purpose of issuing the Section 11(b) bonds for a particular project.

The advantage of the tax-exempt housing subsidy is the reduction it causes in the debt service and thus in the direct Federal subsidy required.[61] Such housing cost reductions are offset by the cost to the Treasury of taxes forgone and the costs to local governments of increased interest rates in the tax-exempt market.[62] Moreover, it is not entirely clear how much of the savings in cost of housing development and operation, obtained through tax-exempt financing by HFDA's, is actually passed on to renters in the form of reduced rents.

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[61] George E. Peterson with Brian Cooper, Tax-Exempt Financing of Housing Investment, Urban Institute, 1979, p. 69.

[62] Peterson and Cooper have estimated that every billion dollars of new housing debt results in approximately $30 million per year in Federal taxes lost to the Treasury and an addition of 4 to 7 basis points to the overall tax-exempt rate, Ibid, pp. 103-104.

(7) Historical Versus Replacements Costs

The argument is sometimes advanced that since depreciation deductions for real estate (as well as other capital assets) are based on historical costs rather than current market or replacement costs, there is a built-in inflation penalty that is inherent in the present depreciation system.

The point is made that historical costs do not rise with the price level. Therefore, the present value of depreciation deductions falls as the rate of inflation rises. What appears to be a very generous depreciation formula for low-income rental housing, for example, may be much less so when inflation reaches double digit levels. On the other hand, there are inflation benefits to investors that tend to be offsetting.

Inflation induces both capital gains and higher interest rates, both of which tend to move in tandem. Investors get to deduct the higher interest costs but defer taxes on capital gains and eventually pay them at lower rates. Hence, the use of historical cost depreciation, rather than replacement cost, can be viewed simply as an offset to the other gains generated for investors by inflation.

C. Economic Recovery Tax Act of 1981

Summary of the Major Changes in Federal Tax Treatment of Rental Housing Investment

This section summarizes the major differences between the Economic Recovery Tax Act of 1981 (ERTA) and the previous Internal Revenue Code in regard to investment in rental housing. Table 3 provides a breakdown of the major Federal tax provisions affecting rental housing investment from the pre-1969 period to the present time.

There are a number of major improvements in the real estate section of ERTA over the previous law. These can best be categorized as simplification of the Code and increased financial incentives, both of which should serve to stimulate investment in real estate.

The real estate changes have vastly simplified the estimation of useful lives for buildings in comparison with the previous system, and permit a much more rapid capital recovery than was previously available to investors. Instead of the previous alternatives available to an investor of using specified Treasury guideline lives or having to provide the proof for facts and circumstances determinations for estimating the tax useful lives of buildings, the current law provides a clear and straight-forward system. Buildings are now generally depreciated over a 15 year period. Investors may take 175 percent declining balance depreciation, changing to straight line for market rental housing and 200 percent declining balance depreciation, changing to straight line, for low-income rental housing.

Table 3

Major Tax Provisions Affecting Rental Housing Investment

Item	Pre-1969 Tax Reform Act	1969 Tax Reform Act	1976 Tax Reform Act	1978 Revenue Act	1981 Economic Recovery Tax Act
Depreciation Method					
Conventional Rental					
New	200% decl. bal. or sum of years digits	Unchanged	Unchanged	Unchanged	175% decl. bal.
Existing	150% decl. bal.	125% decl. bal.	Unchanged	Unchanged	same as new
Low-Income Housing					
New	200% decl. bal. or sum of the years digits	Unchanged	Unchanged	Unchanged	200% decl. bal.
Existing	150% decl. bal.	1) 125% decl. bal.	Unchanged	Unchanged	1) Same as new
		2) Special 60 month amort. for rehab.	Unchanged	Unchanged	2) Unchanged
Tax Useful Lives	30-40 years	Unchanged	Unchanged	Unchanged	15 years. Taxpayer may elect 35 or 45 years. Component depreciation elimi-

(Page 2 of Table 3)

Item	Pre-1969 Tax Reform Act	1969 Tax Reform Act	1976 Tax Reform Act	1978 Revenue Act	1981 Economic Recovery Tax Act
Recapture					
Conventional Rental	Recapture all excess depreciation as ordinary income to the extent of gain.	Unchanged	Unchanged	Unchanged	Unchanged
	Phase-out of recapture when building held more than 20 months by 1% per month.	Unchanged except that phase-out begins after 100 months by 1% per month.	Phase out Eliminated	Unchanged	Unchanged
Low-Income Housing	Same as Conventional Rental	Same as Conventional Rental except that phase-out begins after 20 months at 1% per month.	Unchanged except that phase-out begins after 100 months at 1% per month.	Unchanged	Unchanged
	------	For low-income housing rehab expenditures, excess depreciation recaptured except for phase-out which begins after 100 months at 1% per month.	Unchanged	Unchanged	Unchanged

(Page 3 of Table 3)

Item	Pre-1969 Tax Reform Act	1969 Tax Reform Tax	1976 Tax Reform Act	1978 Revenue Act	1981 Economic Recovery Tax Act
Minimum Tax	- - - - -	10% tax on tax preference items over $30k plus regular income tax payable for year.	15% tax on tax preference items over $10k.	Unchanged, except that untaxed capital gains eliminated from minimum tax.	Unchanged
		Tax preference items include untaxed portion of long-term capital gain and excess deprec.		Alt. minimum tax applies only if greater than normal tax regular minimum tax. Rates on taxable income are $20k to 60k ... 10% 60k to 100k ... 20% Over $100k ... 25%.	Unchanged, except that 25% rate eliminated.
Maximum Tax	- - - - -	Tax on personal service income not to exceed 50%, but tax preference items over 30k reduce amount of earned income eligible for maximum tax treatment.	Unchanged, except that $30k floor changed to -0-	Unchanged, except that untaxed capital gains eliminated for purpose of reducing amount of personal service income available for maximum tax.	Repealed
Capital Gains	Either one-half of long term capital gains taxed or a maximum rate of 25%.	Unchanged, but only for first $50K. Long-term capital gains over $50k: 50% taxed as ordinary income.	Unchanged	60% of long-term capital gains deducted from income. Remaining 40% taxed as ordinary income.	Unchanged

An investor also has the option to take straight line depreciation. In addition, an investor may take a 35 or 45 year tax useful life on a building.

Another major simplification is the elimination of component depreciation, under which investors could allocate the cost of a building to its basic components and then assign a separate tax useful life to each of these components. This exceedingly complex method resulted in separate depreciation schedules for the basic building shell, wiring, roof, plumbing, heating systems, and other identifiable components. This had been a difficult system to administer and there was no assurance that all of the individual useful lives selected by an investor would be approved by the Internal Revenue Service. The 1981 law has eliminated component depreciation and requires the use of composite depreciation. Thus, there is now a single tax useful life for the entire building, and one that is not subject to IRS audit.

Under the previous code, minimum tax provisions on tax preferences functioned as negative tax incentives, that is, as offsets to other tax incentives. Items of tax preference were subject to the minimum tax of 15 percent of the amount by which tax preference items exceeded the greater of $10,000 or one-half the amount of tax otherwise due. Tax preferences reduced dollar-for-dollar the amount of earned income that would have benefited from the 50 percent maximum tax rate on earned income. These negative investment incentives were very complex and onerous to to real estate investors. The negative effects on investors of tax preferences has been reduced considerably by the 1981 law. The special maximum tax provisions have been repealed -- they became redundant when ERTA reduced the maximum tax on income from all sources down to 50 percent. While the minimum tax of 15 percent on tax preference items totalling over $10,000 remains in the law, the rapid capital recovery of 15 years gives investors a useful option to take straight line depreciation, together with the 15 year capital recovery, and thereby avoid the minimum tax on tax preferences as well as recapture.

Another important simplification in the 1981 law is the lack of differentiation between new and used real estate. Under the previous Code there was such a distinction, and different depreciation rates and tax useful lives applied. Under ERTA, a property could receive a 15 year tax useful life irrespective of whether it is new or used. Not only has this change resulted in simplification of the Code, it could result in a significant incentive for the rehabilitation of low-income housing. It permits an investor who purchases a building that needs rehabilitation to elect the use of 175 percent declining balance depreciation and a 15 year useful life. When used in connection with low-income housing, however, the 1981 law permits an investor to elect 200 percent declining balance depreciation and a 15 year tax useful life for the shell and other areas of a building not to be rehabilitated, together with the use of Section 167(k) 60 month amortization for the areas that will be rehabilitated. This combination could be used instead of the previous 125 percent declining balance depreciation and perhaps a 25 year tax useful life for the non-rehabilitated areas and Section 167(k) amortization for the rehabilitated areas. This aspect of the 1981 law has sharply enhanced the attractiveness to investors of housing rehabilitation for low-income families.

The 1981 law has changed the recapture provisions in a significant way. Residential buildings are now treated more favorably than non-residential buildings with respect to recapture. Under the previous Code, only excess depreciation was recaptured as ordinary income for both residential and non-residential buildings. This provision remains the same for residential buildings, but the 1981 law requires recapture of all depreciation deductions taken on non-residential buildings as ordinary income. For example, in contrast to the previous Code, when an investor sells a non-residential building which received accelerated depreciation, the gain on the sale would be treated as ordinary income to the extent of all depreciation deductions. On the other hand, when an investor sells a residential building which similarly received accelerated depreciation, the gain on the sale would be treated as ordinary income only to the extent of the excess of accelerated over straight line depreciation. For non-residential property, an investor can avoid the recapture problem only by using the straight line method of depreciation. This is an important distinction. In addition, the special rule for low-income housing was retained in the 1981 law, under which the liability for the recapture of excess depreciation as ordinary income is reduced by 1 percent per month after 100 months.

II. Effects of the Rental Housing Tax Provisions

A. Introduction

This section addresses the specific issues set forth by the House Committee on Banking, Finance and Urban Affairs. In so doing, it discusses the impacts of Federal tax incentives on the major participants in the rental housing development process. It examines the distribution of benefits in the form of reduced rents to renters, investment returns to real estate investors, and business returns to developers, sponsors and others. It explores the effects of inflation in relation to the costs of development and financing of rental housing. In addition, it considers whether ERTA has restored the tax advantages to rental housing that have been eroded over the past several years.

B. The Impact of Federal Tax Laws on the Production of New Middle-Income Rental Housing

In order to provide a quantitative estimate of the magnitude of the rental housing tax provisions and the impacts of these provisions on value of investment, rents, and the quantity of rental housing, it is necessary to provide a model of how the rental housing market works. Most models of the rental market assume it is quite competitive. Given the existence of large numbers of highly mobile renters, it is unlikely that unwarranted price differentials can exist for very long periods.[63] In addition, in most metropolitan areas, the supply of rental housing is fairly dispersed with no great concentration of rental units in the hands of a small number of owners. Therefore, individual owners are unable to sustain rents at levels above those of competing owners.

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[63] This discussion abstracts from studies of the effects of racial discrimination in housing markets. For an analysis of the extent of racial discrimination, see Kain, J. and Quigley, J., Housing Markets and Racial Discrimination: A Microeconomic Analysis, New York, National Bureau of Economic Research, 1975.

Tax incentives provide benefits to owners and investors of rental housing that serve to reduce the after-tax cost of providing housing services. Such after-tax cost reductions, in turn, increase the rate of return on rental housing investment. Increased rates of return attract capital to rental housing since investment funds in general tend to flow to equalize real after-tax, risk adjusted rates of return.[64] An increased flow of investment capital into the rental market leads to an increase in the quantity of housing services. This happens in many ways, such as increases in the quality of existing units, new construction or conversion from other land uses. As a result, rents fall as owners attempt to attract prospective tenants.

The value to investors of the rental housing tax provisions has been estimated based on the use of predictive models of the housing market by de Leeuw and Ozanne. They found that the present value to investors in new housing of the pre-1981 rental-specific tax incentives were of an order of magnitude of between 10 and 15 percent of the value of a property.

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[64] See Bailey, H.J., "Progressivity and Investment Yields Under U.S. Income Taxation," Journal of Political Economy, Vol 82, 6. November-December 1974, pp. 1157-1175.

This means that an investor in a 50 percent marginal tax bracket would be willing to bid 10 to 15 percent higher for such a property, holding everything else constant, than would be the case if the pre-1981 rental-specific tax incentives were not in the law. The present value to investors of the rental-specific tax benefits increased under the 1981 Act by approximately 9 percent for new buildings and 7 percent for existing buildings, again assuming a 50 percent marginal tax bracket.

Additional analysis by de Leeuw and Ozanne focused on the impact on profitability of the 1969 and 1976 tax law changes. They found that the reductions in profitability to investors in new rental housing were such that rents would have to rise by 9.9 percent to offset the reductions in benefits to owners and investors that resulted from the 1969 and 1976 tax law changes and restore a real after-tax rate of return of 5.58 percent from the 3.84 percent it had fallen to.[65]

Another approach was utilized to estimate the impacts of changes in the Federal tax laws on cash flows to investors, rents, and rental housing production. HUD carried out a simulation model[66] analysis of a rental housing development to estimate what the likely effects would be on after-tax cash flow and rents if depreciation methods were changed. The analysis considered the effects of changes from 200 percent declining balance to straight line and from 175 percent declining balance to 125 percent declining balance. This latter comparison considered depreciation methods available under the 1981 tax law for new and used rental housing and for used rental housing immediately prior to the 1981 tax law. The base case was 200 percent declining balance. The effects of a change in depreciation for nonsubsidized rental housing from the base case of 200 percent declining balance to straight line were (1) a reduction in the rate of return on invested equity of approximately 10.5 percent (from 13.2 percent to 11.9 percent) and (2) an increase in rents necessary to bring the rate of return back to the base case of approximately 5.0 percent.

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[65] De Leeuw, F. and Ozanne, L., "Investment in Housing and the Federal Income Tax," Survey of Current Business, December 1979, pp. 50-61 and an expanded version in Aaron, H. and Pechman, J., How Taxes Affect Economic Behavior, The Brookings Institution, Washington, D.C., 1981, pp. 283-319 (d-0).

[66] REALVAL, a proprietary rental housing model developed by William B. Brueggeman and others.

While the effects may not be strictly linear, it is possible to make some estimates based on this simulation analysis. The depreciation change considered in this case was from 175 percent to 125 percent, a reduction of 50 percentage points, or about 30 percent of 175 percent declining balance depreciation. The model run described above considered a 100 percentage point reduction, or 50 percent of 200 percent declining balance depreciation. Applying three-fifths of the amount of change observed in the model run, there resulted a reduction in the rate of return of 6.3 percent and a 3 percent increase in rents needed to bring the rate of return back to the base case level. It was estimated that if investors were not able to raise the rents on their existing buildings, there would result a reduction in supply of about 3 percent.

The same approach was applied to the after tax cash flow from the project over the first 10 years. The cash flow over a 10 year period came to $316,275 for the base case with 200 percent declining balance depreciation. An assumption of straight line depreciation reduced the cash flow to $199,570, a difference of $116,705. Applying three-fifths of the amount of change observed in the model, resulted in a difference of $77,843 applicable to a depreciation change from 175 percent declining balance to 125 percent declining balance. The present value of this difference was $46,446, or 14.7 percent of the base case cash flow (using a 14 percent discount rate). One of the reasons the figure was so high is that the largest cash flow amounts were generated in the early years and thus were not discounted heavily (see Table 4). The purpose of this exercise was to show how changes in the depreciation rate could affect rents, housing supply, and cash flow returns to investors.

The model run described here simulated an actual garden apartment development in Ohio of 120 units. Rents were assumed to be $177 per month, with an annual growth factor of 5 percent. Property values were estimated to increase by 3.7 percent per year. Tax useful life was 40 years and the test period was 10 years. Operating expenses were assumed to be 43 percent, with a 5 percent growth factor. Investors' marginal tax rate was 50 percent. Selling expenses in year of sale was estimated to be 4 percent.

Table 4

Non-Subsidized Project After-Tax Cash Flow

Base Case (200% Depreciation)	Straight Line Depreciation	Difference (Change from 200% to Straight line)	Adjusted Difference (Change from 175% to 125%)	14% Discount Present Value of Difference
$ 26,995	$ 7,710	$ 19,285	$ 12,863	$ 11,283
27,530	10,170	17,360	11,579	8,909
28,260	12,730	15,530	10,359	6,992
29,170	15,380	13,790	9,198	5,446
30,270	18,130	12,140	8,097	4,205
31,550	20,990	10,560	7,044	3,209
33,000	23,930	9,070	6,050	2,418
34,640	26,990	7,650	5,103	1,789
36,440	30,140	6,300	4,202	1,292
38,420	33,400	5,020	3,348	903
$316,275	$199,570	$116,705	$ 77,843	$ 46,446

C. The Impact of Federal Tax Laws on the Maintenance and Rehabilitation of Existing Rental Housing

As noted in Section I, there was a significant differential in past years in the tax treatment of new and existing rental housing. The rates of depreciation for rental housing between 1969 and 1981 favored new over existing, with 200 percent declining balance depreciation available for new housing as opposed to 125 percent for existing housing. Prior to 1969, the differential in rates of depreciation for the two forms of investment was smaller -- 200 percent for new versus 150 percent for existing. However, used rental housing could be written off over a shorter time period, 20 years as opposed to an average of 32 years for new rental housing. As shown in Table 5, the present value of the depreciation allowance for used rental housing was slightly more ($.41) than that for new rental housing ($.37) under the pre-1981 tax law. Given the relatively small magnitude of difference in the depreciation allowances for new vs. existing rental housing (new investment also enjoys the advantage of amortization of construction period interest and property taxes), it was not likely that the decision to invest in new or existing housing was principally determined by the differential in tax treatment. Rather, it is likely that such decisions were more strongly influenced by expectations of capital gains, stability of rents and the rate of economic depreciation over the anticipated holding period of the investment.

Table 5

Present Value of Depreciation Allowances per $1 of Investment

Asset Type	Pre-1981 Tax Law			Post-1981 Tax Law		
	Method	Recovery Period	Present Value	Method	Recovery Period	Present Value
New Rental Residential	200% D.B.	32 years	$ .369	175% D.B.	15 years	$ .554
Used Rental Residential	125% D.B.	20 years	.412	175% D.B.	15 years	.554
Low-Income Rental Residential	200% D.B.	32 years	.369	200% D.B	15 years	.575
Industrial-Commercial Structure	150% D.B.	36 years	.284	175% D.B.	15 years	.554

D.B. - Declining Balance

Source: Joint Committee on Taxation

Note: This example assumes that investments are held for the entire length of the recovery period and ignores recapture. The discount rate assumed for the analysis is 12 percent.

There is a fundamental linkage between the markets for new and existing housing. In competitive markets, rents are determined at the margin by the costs of constructing new units. A flow of investment funds into the new portion of the market would temporarily lower rents, and some households may respond by renting new as opposed to existing units. The increased demand by tenants for new construction will bid up rents of new units while the excess supply of existing units may lead to a decrease in rents of existing units. Likewise, a shift of households from rental to homeownership can lead to a reduced demand for rental housing, a slowdown in the increase in rents (due to inflation) and less building of new rental housing and/or a faster depreciation of the existing housing stock.

These factors may have led to the increase in the quality of the rental stock that was observed in the 1970's.[67] The late 1960's and early 1970's were record years for new construction of multifamily housing. This period was followed by a period with a relatively low rental unit absorption rate, which indicates some degree of over-building of new rental units. The relative cost of owner-occupancy compared with rental also fell during the 1970's, inducing households to purchase. Both of these factors may have led to a reduced demand for existing rental housing, which may have increased the rate of economic depreciation of existing units. Such economic depreciation probably led to an increased level of abandonment and demolition of older existing units in the early 1970's. The substitution of new for existing units would tend to lead to a quality increase. While the increase in the rate of economic depreciation for existing rental housing was not principally determined by the differential in tax treatment between new and existing rental housing, it is likely that the differential was a contributing factor.

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[67] For details, see U.S. Department of Housing and Urban Development, Policy Development and Research, "Rental Housing: Condition and Outlook," Report to the Congress, September 1981.

As described above, the 1981 Act made a major change in the differential treatment of new and used rental housing. Instead of 200 percent declining balance for new rental housing and 125 percent declining balance for existing, previously available, both new and used rental housing now receive 175 percent declining balance depreciation.[68] Straight-line depreciation, which avoids recapture penalities, was and continues to be available as an option to owners of both types of buildings. In addition, instead of an average of 32 years as the tax useful life for a new rental building and an average of 20 years for a used building, the 1981 law provides a 15 year tax useful life for both new and used rental housing.[69]

To the extent that the 1981 tax law reverses the relatively large capital recovery differentials between new and used rental housing, it can be expected to affect the pattern of the 1980's. The 1981 law encourages a succession of owners for a rental housing property to initiate a new depreciation cycle every 15 years. This could result in a reduction of economic depreciation and longer economic life for existing rental housing units. This longer life may result in a decrease in abandonment and demolition of existing units. Retention of the more deteriorated units suggests a decrease in the overall quality of the rental housing inventory. On the other hand, tax benefits would be swamped by economic losses if succeeding owners permitted their buildings to run down to the point where they cease to be competitive. In addition, the reduction in the rate of inflation can be expected to reduce, at least to some extent, the inflation -related view of homeownership as an investment vehicle. As this occurs, rental housing demand would rise and provide occupants for the longer-lived, used rental units. Finally, the 1981 tax law substantially increases the tax incentives for rental housing rehabilitation. In view of such countervailing forces, it is difficult to project a precise net effect of the new tax law on new vs. used housing.

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[68] Low-income rental housing retained the 200 percent declining balance depreciation method that was permitted under the pre-1981 law.

[69] An owner may elect to take a longer capital recovery period by using a 35 or 45 year tax useful life.

Federal Tax Incentives for the Rehabilitation of Rental Housing

This section describes two Federal tax incentives that encourage the rehabilitation of rental housing. One is for the rehabilitation of residential buildings occupied by low-income households and the other is for the rehabilitation of historic buildings.

Section 167(k)

Section 167(k) was a new program that was added to the Internal Revenue Code by the 1969 Tax Reform Act. The purpose of this section was to encourage private owners and investors to rehabilitate housing for occupancy by low-income families. Section 167(k) was originally scheduled to terminate on January 1, 1975, but has been extended several times, most recently by PL-96-541 on December 17, 1980, and is now scheduled to expire on January 1, 1984.

Section 167(k) allows an owner who rehabilitates housing units to amortize the rehabilitation expenditures over a 60 month period provided that the rehabilitated housing is held for occupancy on a rental basis by low-income families. There are other restrictions on the availability of the deduction. For example, there must be a minimum expenditure for rehabilitation over a consecutive two year period of at least $3,000 per unit, and the total amount of rehabilitation expenditures to be depreciated over the 60 month period may not exceed $20,000 per unit. In addition, the Internal Revenue Service has required strict compliance with administrative rules that call for the submission with the investor's tax return of notarized income certifications from the tenants and detailed supporting data describing the properties.

It is probably misleading to focus on Section 167(k) rental housing rehabilitation as though it were unrelated to other programs. Housing rehabilitation programs targeted only on investors, developers, or tenants have not been able to stand alone in terms of providing a significant supply of low-income housing. High operating costs and low real incomes of tenants preclude even a subsidized rate of return to investors for rehabilitation from being attractive enough relative to other investments to produce low-income rental housing. Low-income rehabilitation needs to be combined with other subsidies to produce available housing. What low-income rehabilitation activity is now being carried out is in combination with other programs, such as Section 8 rent subsidies, Community Development Block Grants and Urban Development Action Grants.

Section 167(k) attracts high-income passive investors seeking to shelter income from taxation. From the standpoint of such investors, low-income rental housing is virtually indistinguishable from cattle breeding, oil and gas exploration, or research and development investment, except for the extent to which it produces a competitive stream of after-tax income. Such passive investors, similar to investors in syndicated assisted rental housing projects, generally know very little about the object of their investment. They probably invest in such projects because their tax advisors recommend these and other tax-advantaged investments for their tax benefits. Because such passive investors have little interest in or knowledge of low-income housing, and would almost certainly not invest in it on their own, a mechanism is needed to bring such investors together to combine their capital, structure the business entity, and operate the project. That mechanism is, of course, the limited partnership syndication.

Section 167(k) has been criticized as representing a complex, inefficient and costly way to raise capital and transfer it to rehabilitation developers. Moreover, because of the many participants in the process and their fees, as detailed above, it is estimated that only half of the government's cost from this tax subsidy ever reaches builders and developers. The rest represents fees to syndicators, lawyers, accountants and others and the value of taxes forgone from passive investors.[70] Notwithstanding the complexity and the cost, "given the pattern of rates of return, incomes of client households and operating costs, it is fairly safe to use as a working assumption that no low-income housing rehabilitation is being done without any subsidies".[71]

Rehabilitation of Historic Buildings

The tax incentive targeted on the preservation of buildings of historic value is a three tier investment tax credit for rehabilitation expenditures under Section 212 of the Economic Recovery Tax Act of 1981. The credit is 15 percent for structures at least 30 years old, 20 percent for structures at least 40 years old, and 25 percent for certified historic structures. No credit is allowed for the rehabilitation of a building less than 30 years old except for a certified historic structure.

The 15 percent and 20 percent investment tax credits are limited to non-residential buildings, but the 25 percent credit is available for residential and non-residential certified historic buildings. The investment tax credits for the rehabilitation of certified historic buidings are available only if the owners of such buidings elect to use the straight-line method of cost recovery for the rehabilitation expenditures. A certified historic building is defined under the 1981 Act as a building listed in the National Register of Historic Places or is located in a registered historic district and certified by the Secretary of Interior to be significant to the district. The 1981 Act repealed the prior rule under Section 167(n) requiring straight-line depreciation for a building located on the site of a demolished or substantially altered certified historic building. It retained the rule, however, under Section 280B, requiring capitalization of demolition costs of a certified historic building or a building in a registered historic district.

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[70] Congressional Budget Office, Real Estate Tax Shelter Subsidies and Direct Subsidy Alternatives, Op. Cit.

[71] The Urban Institute "Technical Proposal in Response to RFP H-5415 to study Sec. 167(k) as a means of Stimulating Private Investment," September, 1981.

D. The Impact of Federal Tax Laws on the Conversion of Existing Rental Housing to Condominium or Other Uses

Condominium conversion results in a change in the legal ownership form of a multifamily residential property from a single owner to multiple ownership. An owner generally sells the apartment building to a converter, an entrepreneur who specializes in converting apartments to condominiums. The converter usually carries out some minor rehabilitation work on the building, including upgrading of mechanical equipment, and sells the units to a new set of owners who may or may not be the former tenants.

The favorable tax treatment of owner-occupied over rental housing has been a driving force in condominium conversions. Prior to 1970, there were few condominium conversions. According to the HUD study on condominium conversion, 366,000 rental housing units have been converted to multiple ownership since 1970.[72] This trend has been accelerating, with 71 percent of this total having been converted between 1977 and 1979. The HUD survey of households involved in the conversion process found that 37 percent of pre-conversion households who purchased their units cited tax advantages and investment considerations as an important factor in their decision to purchase. A recent study of tenure choice in condominium conversions found that the probability of ownership was systematically related to the after-tax costs of owning versus renting.[73]

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[72] Office of Policy Development and Research, U.S. Department of Housing and Urban Development, "The Conversion of Rental Housing to Condominiums and Cooperatives: A National Study of the Scope, Causes and Impacts," June 1980.

The condominium conversion phenomenon coincided with the decline in real after-tax homeownership costs and has been fueled to a great degree by the strong demand for homeownership. In addition, condominium ownership provides smaller and cheaper units for single households and childless couples and satisfies a demand for urban living on the part of many households.

The conversion process may be related to the tax treatment of rental housing. As shown above, it is likely that tax law changes in 1969 and 1976 led to higher rents, holding other factors constant. In addition, there may be an incentive for the conversion process to be handled by third parties, such as professional converters, rather than allowing multifamily building owners to sell directly to tenants or other prospective owners if such an arrangement will prevent the owner from becoming a "dealer." If the owner is deemed to be a dealer, the capital gains derived from the sale (calculated by subtracting the adjusted basis from the aggregate value as owner-occupied units) are taxed as ordinary income. However, if the owner sells to an outside converter, who then sells units to tenants or others, the gains from sale are taxed at capital gains rates subject to any relevant recapture provisions. The differential tax treatment encourages sales to outside converters and may be one factor creating a difference between the value of the building upon sale to the converter and the aggregate value of the individual units when sold to individual homeowners.

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[73] Specifically, the higher the rent and the lower the after-tax homeownership costs the greater the probability of ownership, holding constant income and demographic factors. See Lea, M. and Wasylenko, M., "Tenure Choice and Condominium Conversion," unpublished paper, Office of Policy Development and Research, U.S. Department of Housing and Urban Development, September 1981.

Finally, rental tax provisions may affect the timing of the conversion. Given the nature of the flows of net income and tax benefits over time, there is an optimal holding period which will maximize the present value of the building. The holding period is based on the "crossover point", which is the time when the project begins to generate taxable income after generating tax losses in previous years. An owner who uses accelerated depreciation is likely to reach the "crossover point" on his property sooner than if he used the straight line method, other things being equal. In addition, expectations by owners of rental housing developments of the future course of homeownership demand, rental demand, and the value of the remaining flow of tax shelter benefits, will be important determinants of the decision to convert the property.

There has been some debate on the causes of condominium conversion. Probably the most important causes have been the decline in real after-tax homeownership costs, the effects of the 1969 and 1976 tax law changes on rents, and the tax incentives for conversion. The 1981 tax law reverses much of the 1969 and 1976 effect on rents. It does not, however, remove the tax incentive for conversion. In addition, there are probably strong contributing factors that tend to reinforce the trend of apartment conversion to condominiums. These include an apparent decline in the profitability of multifamily housing ownership due to rapidly growing operating and maintenance costs, higher land and construction costs, and increased government regulation.[74] Additionally, a growing militancy of tenants is resulting in local rent control measures or consideration of such measures by local governments. The fear of rent control and related local regulatory legislation has no doubt been a contributing factor to conversion.

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[74] U.S. Department of Housing and Urban Development, "The Conversion of Rental Housing to Condominiums and Cooperatives: A National Study of the Scope, Causes and Impact," Op. Cit.

E. The Impact of Federal Tax Laws on Tenants Residing in Rental Housing or Prospective Tenants of Rental Housing

On the surface, given the competitive nature of the rental housing market, it is likely that most of the benefits of rental specific tax provisions accrue to renters. In the short-run, owners of rental property may benefit from a favorable change in rental provisions, but the enhanced rate of return will attract more investment and, as discussed above, lead to lower rents (than in the absence of such favorable provisions.) Tax benefits that lead to decreases in rents are progressive in nature. This is evident in examining Table 6 which shows a distribution of renters by income class. In 1979, over 68 percent of the renter population had incomes in 1974 dollars of less than $10,000. Conversely, tax changes that lead to rent increases will tend to be regressive in nature.

The deLeeuw and Ozanne studies brought to light some of the quantitative effects of Federal tax laws on tenants.[75] For example they found that the tax law change in 1978 (reducing the capital gains tax rate) that increased the present value of a representative rental housing investment by 1.8 percent would have decreased rents by 4.2 percent. This result is similar to that of Brueggeman, Fisher and Stern who found that with a slightly different model, the 1978 tax law change would have lowered rents in a representative project by 4.4 percent.[76] The results of the de Leeuw and Ozanne and the Brueggeman, Fisher and Stern studies are summarized in Table 7.

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[75] DeLeeuw, F. and Ozanne, L., Op. Cit.

[76] Bruggeman, W., Fisher, J., and Stern, J., "Federal Tax Treatment of Rental Residential Housing: Cumulative Effects and Proposed Changes," Op. Cit.

Table 6

Renter Households by Income Class
(1974 dollars)

	1974		1979	
	#	%	#	%
< 5,000	6,410	28.98	7,602	31.80
5-10,000	7,002	31.66	8,737	36.55
10-20,000	6,947	31.41	6,323	26.45
20-30,000	1,281	5.79	966	4.04
30,000+	479	2.16	278	1.16
Total	22,119	100.0	23,907	100.0
Median	7,700		6,993	

SOURCE: U.S. Bureau of the Census, and U.S. Department of Housing and Urban Development, Annual Housing Survey: Part C, Financial Characteristics of the Housing Inventory, 1974 and 1979.

The effect of a tax-induced change in rent levels on rental markets depends on the price elasticity of rental demand. Recent estimates of the price elasticity of demand for housing based on individual data suggest that it is in the neighborhood of 0.5 to 1.0 in absolute terms. It tends to be lower for low-income households and renters than for high-income households and owners and varies by household characteristics.[77] If we assume a price elasticity of demand of 0.75 in absolute value, a 20 percent decrease in rents would lead to a 15 percent increase in the quantity of housing services demanded.

The net effect of a tax change resulting in a 20 percent decrease in rents is likely to be somewhat less than 15 percent, however, since the supply curve is likely to be less than perfectly elastic, particularly in the short-run. However, research has suggested that housing supply may be quite elastic in the long-run, in which case the change in the stock of rental housing, holding other factors constant, may be close to the 15 percent suggested by these estimates.[78] It should be emphasized that this is a partial market analysis, focusing on the rental housing market in isolation. Concomitant changes in the after-tax returns to other assets will change the magnitude of these results.

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[77] For a more detailed discussion of price elasticities, see Follain, J., "A Study of the Demand for Housing by Low versus High Income Households ," Journal of Financial and Quantitative Analysis, November 1979, pp. 769-782.

[78] de Leeuw, F. and Ekanem, N., "The Supply of Rental Housing." American Economic Review, December 1971, pp. 806-817.

Table 7

Effects of Tax Legislation on Rents in Newly Constructed Buildings

	% Change in Rents	
	d-O	B-F-S
1969 and 1976 changes[1]	9.9	12.5
1978 changes[2]	-4.2	-4.4
1981 changes[3]	-	-32.7

NOTE: These results assume a 6 percent inflation rate, a real after-tax rate of return for housing investors of 4 percent, and apply to a new rental housing investment.

[1] Provisions for recapture (taxation as ordinary income rather than capital gains) of excess over straight-line depreciation for properties held less than depreciable life, introduction of a minimum tax on tax preference income such as accelerated depreciation and amortization rather than expensing of construction period interest and taxes.

[2] Reduction from 50 to 40 percent in the proportion of capital gains subject to income taxation.

[3] Reduction in depreciable life from an average of 30-35 years to 15 years and a reduction of the depreciation rate from 200 percent declining balance to 175 percent declining balance.

SOURCES:

de Leeuw, F. and Ozanne, L., "Investment in Housing and the Federal Income Tax," Survey of Current Business, 59, December 1979, pp. 50-61 and an expanded version in Aaron, H. and Pechman, J., How Taxes Affect Economic Behavior, The Brookings Institution, Washington, D.C., 1981, pp.283-219 (d-O).

Brueggeman, W., Fischer, J., and Stern, J., "Federal Tax Treatment of Rental Residential Housing: Cumulative Effects and Proposed Changes," paper presented at the Conference on Taxes Mortgage Instruments and Housing. Some Results from Simulation Models, The Ohio State University, Columbus, Ohio, September 11-12, 1981.

In addition to affecting rental consumption, an increase in rent will lead to an increase in the proportion of households choosing to own relative to households choosing to rent. Research in the area of tenure choice indicates that household tenure choice decisions are responsive to relative prices as well as income and demographic factors. Utilizing an estimate of the elasticity of tenure choice with respect to rent of 0.67 developed by Rosen, de Leeuw and Ozanne estimated that the renter fraction of all households would have decreased by 6.5 percent due to the 1969 and 1976 tax law changes and would have increased by 2.9 percent due to the favorable tax legislation of 1978.[79] It should be emphasized that this estimate does not control for other factors influencing tenure choice and, therefore, does not "explain" tenure shifts that occurred during the period.

There is a group of households whose tenure decisions may be quite responsive to relative prices, but a large number of households may choose to rent or own based on other factors, such as expected mobility and life-cycle considerations. While the direction of tenure shifts is known, the magnitude attributed to changes in relative prices should be viewed with caution.

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[79] Rosen, H., "Housing Decisions and the U.S. Income Tax," Journal of Public Economics, 11, 1979, pp. 1-23.

F. The Potential Impacts of the Economic Recovery Tax Act of 1981 on Rental Housing Investment

The real estate section of the Economic Recovery Tax Act of 1981 is very favorable to real estate investment.

The 1981 law vastly simplified the applicable tax laws and sharply increased the investment incentives for real estate investment, and in particular, for rental housing. Investors are now able to select very attractive tax useful lives for their buildings without having to worry about IRS challenge on components. In addition, it provides flexibility to real estate investors by permitting them to choose a capital recovery period and depreciation method that best suits their needs. While the major changes on balance have narrowed tax advantages for rental housing compared with other investments, the revised Code still favors rental housing over non-residential buildings.

Notwithstanding the favorable treatment of rental housing under the 1981 law, there could be a flow of some investment capital out of rental housing and into the construction of office buildings, shopping centers and other non-residential buildings. Under the previous law, depreciation of non-residential buildings could not exceed 150 percent declining balance and excess depreciation was subject to full recapture. Even though the recapture provisions for non-residential buildings were made somewhat less beneficial under the 1981 law, as described above, the overall capital recovery was improved to a greater extent for non-residential buildings than it was for rental housing. Non-residential buildings can now take 175 percent declining balance depreciation. In addition, the tax useful life for non-residential buildings was reduced to 15 years from generally much longer periods than was the case for residential buildings. For example, office buildings, banks, and warehouses had tax useful lives of 45 years, 50 years and 60 years respectively under the previous Code.

This potential movement of investment capital away from rental housing could be reinforced by the substantially more attractive tax allowances than were available under the previous Code for machinery and equipment. The simplified and speeded-up capital recovery system and the increased investment tax credit favor non-residential investments.

Chairman STARK. Mr. Matland.

STATEMENT OF KIM Q. MATLAND, COUNSEL, ASSOCIATION OF PRIVATE PENSION AND WELFARE PLANS, INC.

Mr. MATLAND. Yes.

Mr. Chairman and members of the subcommittee, my name is Kim Matland. I am with the law firm of Steptoe & Johnson, Chartered. It is my pleasure to appear today on behalf of the Association of Private Pension and Welfare Plans, Inc. The APPWP appreciates this opportunity to offer comments regarding H.R. 3592 and H.R. 3173.

Let me turn first to H.R. 3592. We fully support the pension portion of the bill. There are, however, a few modifications to H.R. 3592 which we urge you to adopt in the interest of expansion and simplification of the rollover concept. The first suggestion relates to a requirement in H.R. 3592 that in order for a participant to utilize the partial rollover, such individual must receive at least 50 percent of his or her balance under the plan. Limitations such as this will only lead to complexity and confusion. Furthermore, it appears that there are already adequate safeguards in H.R. 3592 against tax abuse as a result of a partial rollover; that is, the loss of net unrealized appreciation on employer securities in the partial rollover and the loss of 10-year averaging and capital gains treatment for any further distributions from the plan. Accordingly, we urge you to eliminate any limitation on the amount that may be rolled over into an IRA.

Our second suggested modification would expand the provisions of H.R. 3592 to permit a rollover from an IRA to a qualified retirement plan. Prior to the enactment of ERTA, rollovers from an IRA to a qualified retirement plan were not permitted primarily because a qualified retirement plan provided favorable tax treatment for distributions, without subjecting such distributions to various restrictions applicable to distributions from an IRA.

With the enactment of ERTA, however, participants in a qualified retirement plan are permitted to make deductible employee contributions to the plan which are subject to limits and restrictions virtually identical to those applicable to IRA's. Therefore, we urge you to expand the rollover rules to permit an individual who maintains an IRA and wishes to combine this with the balance retained in his qualified retirement plan, to do so, if the qualified retirement plan will accept deductible employee contributions and the rollover amount is held as a deductible employee contribution.

One final modification with respect to H.R. 3592 relates to the high-25 rule. Under certain circumstances, current law provides that if one of the top 25 highest paid employees wishes to roll over a distribution from his or her defined benefit plan, the employee must receive the entire balance to his credit under the plan and provide security equal to the restrictive amount prescribed by regulation or post a bond to pay such amount.

H.R. 3592 would provide an employee in this group with some greater flexibility than he has now by permitting him to receive a partial distribution and roll over such amount into an IRA. We believe, however, that the bill should be modified to permit these individuals to receive a distribution of their entire interest and roll it over into an IRA, if the qualified retirement plan is given a security interest in the IRA equal to the restricted portion of the distribution.

I would like to turn next to H.R. 3173, a bill which would permit certain money purchase plans to provide cash or deferred arrangements. The principal reason for the growth of cash and deferred arrangements has been the fact that under a cash or deferred profit-sharing plan, employees with differing interests in saving for retirement security have the flexibility to decide for themselves how much should be set aside for this purpose.

For this reason, we support H.R. 3173, but urge that you expand the provisions of H.R. 3173 to cover all money purchase plans so that many more employees will become eligible to save additional amounts for their retirement security. For example, organizations which are prohibited from having a profit-sharing arrangement and therefore find it impossible to adopt a 401(k) plan, would be able to provide their employees with a cash or deferred option. This would be of particular use, for instance, to tax-exempt organizations. In addition, it also would permit organizations without strong profit positions and therefore little or no earnings and profits to promote cash or deferred arrangements. The Federal policy of encouraging employees to save their own money for retirement should not discriminate against employees who work for less profitable employers.

We thank you for this opportunity to appear before you and would be happy to assist you or your staff as these bills are considered.

[The prepared statement follows:]

STATEMENT OF KIM Q. MATLAND, ASSOCIATION OF PRIVATE PENSION AND WELFARE PLANS, INC.

Mr. Chairman and members of the Subcommittee, my name is Kim Q. Matland, and I am with the law firm of Steptoe & Johnson, Chartered. It is my pleasure to appear today on behalf of the Association of Private Pension and Welfare Plans, Inc. (APPWP). The APPWP is a non-profit organization founded in 1967 with the primary goal of protecting and fostering the growth of this country's private pension system. The Association represents some 600 organizations located across the United States. Our member firms include hundreds of plan sponsors—both large and small employers alike. Additionally, our membership includes leading organizations from every element of the employee benefits community which supports the nation's private benefit system: investment firms, banks, insurance companies, and various others associated with employee benefit plans. Collectively, APPWP's membership is involved directly with the vast majority of employee benefit plans maintained by the private sector.

The APPWP appreciates this opportunity to offer comments regarding H.R. 3592 and 3173, two measures which will contribute to the enhancement of the private pension system. Let me turn first to H.R. 3592. We fully support this bill which would permit the rollover to an individual retirement account ("IRA") of certain partial distributions from qualified retirement plans. We believe that the concept of tax-free rollovers, introduced in the Employee Retirement Income Security Act of 1974 ("ERISA"), should be expanded and simplified to provide to as many participants as possible the means to preserve their retirement benefits.

There are, however, a few modifications to H.R. 3592 which we urge you to adopt in the interest of expansion and simplification of the rollover concept. The first suggestion relates to the requirement in H.R. 3592 that in order for a participant to utilize the partial rollover, such individual must receive at least 50 percent of his or her balance under the plan. Limitations such as this will only lead to complexity and confusion for participants who wish to take advantage of a partial rollover. Furthermore, it appears that there already are adequate safeguards in H.R. 3592 against tax abuse as a result of a partial rollover. When a participant elects partial rollover treatment, the advantages of ten-year averaging, capital gains treatment, and net unrealized appreciation on employer securities would not be available for any further distributions from the plan. The loss of this favorable tax treatment will be adequate to discourage participants from attempting to manipulate their tax liability through the use of partial rollovers. Accordingly, we urge you to eliminate any limitation on the percentage of a participant's balance in a qualified retirement plan that may be rolled over into an IRA.

Our second suggested modification would expand the provisions of H.R. 3592 to permit a rollover from an IRA to a qualified retirement plan. Prior to the enactment of the Economic Recovery Tax Act of 1981 ("ERTA"), rollovers from an IRA to a qualified retirement plan were not permitted primarily because a qualified retirement plan provided favorable tax treatment for distributions without subjecting such distributions to various restrictions applicable to distributions from an IRA. Thus, if an individual could have rolled over amounts from his IRA into his qualified retirement plan, he could have avoided the IRA restrictions and still received favorable tax advantages not otherwise available to IRA participants. With the enactment of ERTA, however, participants in a qualified retirement plan are permitted to make deductible employee contributions to the plan which are subject to limits and restrictions virtually identical to those applicable to IRAs. Moreover, the favorable tax treatment, otherwise available for distributions from a qualified retirement plan, is not applicable to deductible employee contributions. Accordingly, we now have a vehicle within a qualified retirement plan which is subject to essentially the same restrictions as an IRA and which could be used to permit an individual to roll over amounts distributed from an IRA without any potential for tax abuse. Therefore, we urge you to expand the rollover rules to permit an individual, who maintains an IRA and wishes to combine this with the balance retained in his qualified retirement plan, to do so if the qualified retirement plan will accept deductible employee contributions and the rollover amount is held as a deductible employee contribution.

One final modification with respect to H.R. 3592 relates to restrictions on the receipt by a plan participant, who is among the top 25 highest paid employees, of his or her full account balance within 10 years after the plan was established or amended to provide benefit increases. These restrictions, which were initially developed over 20 years ago to prohibit or limit potential discrimination in favor of officers, shareholders and highly compensated employees in the event of an early termination of a qualified retirement plan, should be repealed because ERISA adequately controls the abuses they were designed to remedy. However, in the alternative, we suggest that H.R. 3592 be modified to permit a highly paid participant more flexibility so long as the integrity of the plan is assured.

A highly paid employee now may not receive his full balance under a defined benefit plan unless he either provides security equal to the restricted amount prescribed by regulations or posts a bond to pay such amount. Under current law, if such an employee wishes to roll over a distribution from the plan, the employee must receive the entire balance to his credit under the plan and, therefore, must put up security or a bond. H.R. 3592 would provide an employee in this group with some greater flexibility than he has now by permitting him to receive a partial distribution and roll over such amount into an IRA. We believe, however, that the bill should be modified to permit these individuals to receive a distribution of their entire interest and roll it over into an IRA if the qualified retirement plan is given a security interest in the IRA equal to the restricted portion of the distribution. This logical method of dealing with the limitation on the 25 highest paid employees was recently approved by the IRS with respect to the transfer of amounts to an H.R. 10 plan. However, the IRS seems unwilling to extend such treatment to IRAs. Therefore, we urge you to modify the bill to give this added flexibility to all participants.

I would like to turn next to H.R. 3173, a bill which would permit certain money purchase plans to provide cash or deferred arrangements. Since the enactment of the cash or deferred profit-sharing plan provision in 1978, and the publication of IRS regulations thereunder, cash or deferred arrangements have proven to be popular with employers/plan sponsors and their employees. The principal reason for the growth of such arrangements has been the fact that under a cash or deferred profit-sharing plan employees with differing interests in saving for retirement security have the flexibility to decide for themselves how much should be set aside for this purpose. Because cash or deferred arrangements provide an efficient and flexible means to provide retirement security for a heterogeneous group of employees, we support H.R. 3173 but urge that you expand the provisions of H.R. 3173 to cover all money purchase plans.

We believe that if the bill is expanded in this manner, many more employees will become eligible to save additional amounts for their retirement security. For example, organizations which are prohibited from having a profit-sharing arrangement and therefore find it impossible to adopt a § 401(k) plan, would be able to provide their employees with a cash or deferred option. This would be of particular use, for instance, to tax-exempt organizations. In addition, it also would permit organizations without strong profit positions and, therefore, little or no earnings and profits, to promote cash or deferred arrangements. The federal policy of encouraging employees to save their own money for retirement should not discriminate against employees who work for less profitable employers. Accordingly, we support H.R. 3173 and vigorously urge its expansion to permit all money purchase plans to have cash or deferred arrangments.

We thank you for this opportunity to appear before you and would be happy to assist you or your staff as these bills are considered.

Chairman STARK. Thank you.

Did you have anything to add, Mr. Stevens?

Mr. STEVENS. No, Mr. Chairman.

Chairman STARK. I guess, Mr. Schwartzberg, the only thing I can say, it is very difficult to determine what your mother meant when she said enough is enough. I see joint venture housing deals that pay out a tax shelter in a couple of years and when you combine them with the historic 25-percent rehab credit, they literally put cash in your pocket. You borrow out and walk away with cash, and I think that is too much. That isn't what we meant in terms of subsidizing.

Also, there are some pretty horrendous shelter deals that come to light. That is the problem we have in deciding when a law is indeed reasonable, when we are limiting somebody's flexibility, and when we are creating a terrific opportunity to game us. Staff will spend some time on it. I hope we can find something.

Mr. SCHWARTZBERG. What I would like to point out is in my 15 years in the industry, I have never seen HUD take a more active role than it is in the resyndication. That is what we are here to talk about, of existing Government-assisted housing developments.

The industry has no new production incentives, so we had to step back and look what happened over the last two decades, trying to keep up with a lot of the theory that never turned into fact over a period of years.

We are concerned about abuses. Also, we are responsible members of the industry doing a great deal of housing investments and we are always concerned about those number of shelter merchants, if I can use the phrase, that abuse the industry. In effect what we are doing, is that we are throwing the baby out with the bath water. There is a housing stock shortage.

Chairman STARK. I appreciate your testimony. I just say you are in an area where a lot of gaming has gone on. We will try and be as definitive as we can.

We appreciate your testimony.

Mr. SCHWARTZBERG. Thank you.

Chairman STARK. Our next witness is Kenneth Gideon, former chief counsel of the IRS and now counsel for the Association for the Care of Children's Health. Mr. Gideon is here to testify on H.R. 3593. Welcome, Ken, you may proceed in any manner you wish.

STATEMENT OF KENNETH W. GIDEON, COUNSEL, ON BEHALF OF THE ASSOCIATION FOR THE CARE OF CHILDREN'S HEALTH; THE CANDLELIGHTERS; AND DEPARTMENT OF PEDIATRICS, BAYLOR COLLEGE OF MEDICINE, HOUSTON, TEX.

Mr. GIDEON. Thank you, Mr. Chairman.

I am Kenneth W. Gideon, a partner in the Washington office of the law firm of Fulbright & Jaworski. I am appearing here today on behalf of the Association for the Care of Children's Health, an international association which concerns itself with improvement of health care for children, the Candlelighters, a network of parent support organizations throughout the Nation dealing with childhood cancer, and the Department of Pediatrics of Baylor College of Medicine of Houston, Tex.

All of these organizations strongly favor legislation designed to provide relief for parents of children for whom outpatient care if often the most therapeutic and most efficient alternative. Under present law, even if the 5 percent of adjusted gross income test for deductibility of medical expenses is met, expenses for meals and lodging incurred while receiving care on an outpatient basis are not deductible.

In addition, no deduction is permitted for the lodging and meal costs of a parent or guardian accompanying a child who is receiving such care, even though it clearly would not be feasible for the child to be treated on an outpatient basis absent such accompaniment.

This situation creates an undesirable and inefficient bias in favor of in-hospital care. Even more significantly, however, the exclusion of such expenses from the category of deductible medical elxpenses works real hardship on those whose ability to pay income tax has been significantly impaired by incurring heavy, medically necessary, but presently nondeductible expenditures. Tax relief for such expenditures is clearly consistent with the underlying policy of the extraordinary medical expense deduction.

With the striking advances that have been made in recent years in the treatment and diagnosis of chronic children's diseases, specialized centers have developed throughout the country for the treatment of these diseases. It is frequently necessary for the afflicted child and accompanying parent or guardian to travel some distance from home to the specialized center providing care for the child's particular medical problem.

There has also been a clear trend, particularly in the treatment of childhood cancer, toward outpatient, as opposed to in-hospital care. Under present law, the child's lodging and meals in a hospital would be deductible medical expense—but if the child receives the same treatment on an outpatient basis, no lodging and meals are deductible, as we stated before.

Moreover, while the presence of a parent or guardian with the child during this period of treatment is clearly necessary, the cost of the parent or guardian's food and lodging is totally nondeductible.

While many similar examples could be given, consider the case of a child with leukemia receiving a course of chemotherapy over a period of 6 weeks. Hospital confinement during the entire period in many such instances is neither desirable therapeutically nor cost efficient. Yet, during that 6 weeks, parent and child, living on the most frugal of budgets, will incur very substantial lodging and meal costs—and will have to pay taxes on the dollars used to pay those costs.

We are well aware, however, that any relief provision presents the possibility of abuse by those who are not suffering financial hardship and who are seeking medical procedures which may not be necessary. For this reason, the organizations for which I am testifying today fully support the inclusion of reasonable safeguards in any provision ultimately enacted to assure that it benefits only those truly in need of such relief. For example, deductible expenditures could be limited to those which are: For living expenses away from home; not lavish or extravagant under the circumstances; primarily for and essential to medical care; provided by a physician in a licensed hospital or in a recognized medical care facility; or incurred with no significant element of personal pleasure, recreation, or vacation in the travel away from home.

Substantial additional specificity can be developed in the regulations process. We stand ready, however, to work with the committee and the staff in developing any additional safeguards felt to be necessary, and we are confident that a statutory provision can be developed which will provide relief to the deserving while minimizing the potential for abuse.

Summing up, we commend the committee and the sponsors of H.R. 3593, H.R. 2720, and S. 824, Congressmen Stark, Conable, Field, and Archer, and Senator Bentsen, for bringing this important issue before the Congress.

We urge the enactment of legislation providing a deduction for the cost of a child's meals and lodging incurred to obtain medically necessary treatment—with appropriate safeguards against abuse. We think it essential that the expenses of an accompanying parent or guardian be made deductible as well.

I might add, Mr. Chairman, while there was not time to prepare a formal statement on behalf of representatives of the American Cancer Society and the American Kidney Fund, they have authorized me to state today that they are very concerned with this problem for adult patients as well as children and support efforts to achieve a congressional resolution.

I will be pleased to answer any questions which you might have.

Chairman **Stark**. Mr. Gideon, as a coauthor of this bill, your words fall on receptive ears. I appreciate your taking the time to be with us today.

Thank you very much.

Mr. **Gideon**. Thank you.

Chairman **Stark**. The subcommittee stands adjourned, subject to the call of the Chair.

[Whereupon, at 2:20 p.m., the hearing was adjourned.]

MISCELLANEOUS TAX BILLS

THURSDAY, NOVEMBER 3, 1983

House of Representatives,
Committee on Ways and Means,
Subcommittee on Select Revenue Measures,
Washington, D.C.

The subcommittee met at 2 p.m., pursuant to notice, in room B-318, Rayburn House Office Building, Hon. Fortney H. (Pete) Stark (chairman of the subcommittee) presiding.

Chairman Stark. Mr. Secretary, welcome to the committee. We are meeting now to consider eight miscellaneous tax bills. I would ask unanimous consent that the press releases announcing this hearing be made a part of the record. We are pleased to have you here testifying on H.R. 4206.

We understand the limitations on your time. Welcome. The subcommittee is honored. We usually see you only in the full committee and, in the interest of your time and schedule, you may proceed in any fashion you see fit.

If you have a prepared statement it will appear in the record in its entirety. We are glad to have you here. Proceed.

STATEMENT OF HON. DONALD T. REGAN, SECRETARY, DEPARTMENT OF THE TREASURY

Secretary Regan. Thank you, Mr. Chairman. I know this is rather unusual, my making this appearance, but this is a personal thing with me. Not only am I a former marine and therefore have a predilection toward doing anything we can to make the plight of families of servicemen who are killed in action more tolerable, but also I have some anecdotal evidence to share with this committee concerning members of my own family.

My father-in-law was killed under these circumstances early on. My mother-in-law, as a widow, brought up my wife and two other children.

The children were ages 7, 5, and 4 at the time her husband was killed while in the Marine Corps serving abroad not in a war zone. It was indeed difficult on that family, and I know what they went through so I can empathize with widows who are going to go through the same thing as a result of the untimely death of their spouses in these actions.

I think both the executive branch and the legislative branch must act as responsible people when we place our servicemen in these precarious positions in which they are subject to some type of hostile or unfriendly fire. If as a result of that duty the servicemen receive wounds or are otherwise killed, the IRS must not extract the last ounce from them by stating that they must then pay income tax. I think that is going a little bit too far, Mr. Chairman, and that is why I welcomed the fact that Mr. Archer was able to introduce a bill to this effect.

I would certainly hope, Mr. Chairman, that the subcommittee and then the full committee and indeed the Congress would see fit to pass this as quickly as possible so that the families of those who were killed not only in Lebanon but also in Grenada would know that they did not have to go through this unusual burden of having to settle with the IRS on top of everything else they are going through.

Chairman STARK. Mr. Secretary, I could not agree with you more, and I appreciate your taking the time to share the tragic events in your own family's history. It occurs to me we often have had civilian employees of the Federal Government working in embassies where hostile action has killed them.

We have had, indeed, our own colleague, Leo Ryan, for example, a late Member of Congress, who was killed in Guyana as a result of hostile action. Would it seem appropriate for this committee to investigate extending this to any Federal employee on official business killed as a result of hostile action overseas?

Secretary REGAN. We at Treasury would certainly work along with this committee in exploring that one, Mr. Chairman.

Chairman STARK. I appreciate it.

Mr. Duncan.

Mr. DUNCAN. I have no questions, and I thank the Secretary.

Chairman STARK. Mr. Dorgan.

Mr. DORGAN. I have no questions.

Chairman STARK. Thank you very much, Mr. Secretary.

Secretary REGAN. Thank you.

Chairman STARK. Mr. Archer, the author of the legislation and an esteemed colleague and member of the full Committee on Ways and Means, will be our next witness.

STATEMENT OF HON. BILL ARCHER, A REPRESENTATIVE IN CONGRESS FROM THE STATE OF TEXAS

Mr. ARCHER. Thank you very much, Mr. Chairman, for permitting us to have this hearing so expeditiously. I also want to thank you for cosponsoring this legislation.

I think all of us are painfully aware of how little we can do to help the anguish of the families of servicemen who have died recently. There is perhaps as Secretary Regan said, however, something we can do to help them in their financial stress, and that is the purpose of this bill.

Current law provides for a tax exemption for the incomes of those members of the Armed Forces who die as a result of wounds, disease, or injury, and—I quote the statute—"while serving in an area designated as a combat zone by executive order of the President of the United States."

Unfortunately there are occasions when for many reasons the President is unable to designate an area as a combat zone, and we have seen an example of that in Lebanon. In my opinion those servicemen who die in that type of situation are really no different than those who died in Vietnam, which was the last zone declared a combat zone by Executive order.

I believe we should treat them exactly the same and give them an exception from income tax on their incomes in the year of death and the year prior to that in which they served in that area on a continuous basis. I do not think their survivors should be denied this benefit which has been given to others in the past, and H.R. 4206, my legislation, addresses that inequity by providing an exemption for those who are killed in hostile action.

It would be intended to include those who were killed in the abortive rescue effort in Iran. It would include those assigned to the U.N. peacekeeping force in Lebanon who were killed and all American servicemen who have been killed while serving recently in Lebanon and Grenada.

In addition, any servicemen who have died in Central America as a result of hostile action would be covered, and it would include those occurrances in the future. In the very short time since this bill has been introduced, over 100 Members of the House have joined as cosponsors and 25 members of the Ways and Means Committee have joined.

I think it is clear there is a great interest in acting expeditiously on this bill, and I again want to thank the Chairman for permitting us this very quick hearing.

[The prepared statement follows:]

STATEMENT OF HON. BILL ARCHER, A REPRESENTATIVE IN CONGRESS FROM THE STATE OF TEXAS

Mr. Chairman, I deeply appreciate this opportunity to appear before your subcommittee today—and I am especially grateful for the expeditious manner in which you and the staff have scheduled hearings on H.R. 4206 just a week after its introduction.

I think all of us are painfully aware of how little we can do to help relieve the anguish of the families of our servicemen and women who die overseas in the service of their country. There is perhaps, however, at least one small way in which we can help relieve a portion of the anxiety felt by some of those families caused by the economic loss which they will also feel.

Current law provides for a tax exemption for the incomes of those members of the Armed Forces who die as a result of wounds, disease or injury while serving in an area designated as a "combat zone" by executive order of the President. Unfortunately, there are occasions—several in recent history—where servicemen have died as a result of hostile action in areas which have not been designated as "combat zones." In fact, no such designation has been made since Vietnam, and yet our young men have died in the line of duty in such places as Iran, Lebanon and Grenada. The grim reality of their deaths is the same. The only difference is the absence of a "combat zone" designation for the places in which they died.

Surely our tax laws should not deny their suvrivors the same benefits accorded the survivors of those who have died in the past in Vietnam and other Presidentially designated "combat zones."

H.R. 4206 addresses that inequity by providing an exemption for those members of the Armed Forces who die as a result of hostile action while serving overseas. The bill is specifically designed to apply to such instances as those who died in the Iranian hostage rescue attempt, U.S. officers killed by land mines while assigned to the U.S. peace-keeping force in Lebanon, all American servicemen who have been killed while serving in U.S. contingents in Lebanon and Grenada, our servicemen who have died in Central America and all other such cases which have occurred since the effective date of the bill—as well as occurrences in the future.

In very short time since the bill's introduction, more than 100 Members of the House have joined as cosponsors. Of that number 10 are members of this subcommittee. 25 are members of the full Ways and Means Committee. Companion legislation was introduced yesterday in the Senate and is expected to quickly receive similar support.

I think it's clear that there is a great interest in acting expeditiously on H.R. 4206, and I commend the subcommittee for its assistance in making early consideration possible.

Thank you very much. I'll be glad to respond to any questions the members may have.

Chairman **Stark**. Thank you very much, Mr. Archer.

Would the author of the legislation care to comment on the Chair's idea that civilian employees of the Federal Government, who are often side-by-side with the military personnel involved, and have been killed as a result of the same hostile actions should be included in this?

Mr. **Archer**. Mr. Chairman, I discussed that just this morning with my staff because I personally was concerned about this in the same way that you are. The reason that we included in the original draft of the bill only military personnel is because they are currently included under the Code where there is a combat zone designated.

Civilians are not and we felt we ought to try to the greatest degree possible to track the current law. I certainly would have no objection to such an amendment.

In fact, I would feel it appropriate, if properly defined and properly limited. I would say it is my intention to include those deaths that result directly from hostile action, not all of those deaths which in the past may have been construed to be in the line of duty.

For example, if a serviceman happened to get in a brawl and be killed with one of his fellow servicemen, that situation would not be covered. If he died in an automobile accident that was civilian in nature, that case as well would not be covered under my bill. I think it is important that we do limit the scope to those situations which are clearly the result of hostile action.

The type of things I would intend to cover would be, as I mentioned earlier individuals serving in a multinational peacekeeping force such as existed in Lebanon. It would cover land mines. It would cover terrorist bombs in addition to actual combat, as well as sniper fire or the collision of a ship that was adjacent to the area in which hostilities existed.

I also would point out for the subcommittee that the bill does go back and picks up those tax years, beginning January of 1980, still eligible to be open for amendment. That is why I picked the date of December 31, 1979. The revenue loss obviously is minimal.

Chairman **Stark**. I thank the gentleman very much. If the Chair could go off the record for a moment.

[Discussion off the record.]

Chairman **Stark**. Back on the record. I would ask Mr. Duncan if he would like to inquire.

Mr. **Duncan**. I would like to compliment our colleague on his aggressiveness in this very important, and vital piece of legislation which I believe most people should support. I thank you, Bill.

Mr. **Archer**. I thank you.

Mr. **Dorgan**. Let me echo Mr. Duncan's comments. I think this is a good piece of legislation for which you will find wide support.

Chairman **Stark**. Mr. Moore.

Mr. **Moore**. I would like to compliment the gentlemen. I was glad to join him as a coauthor, and I would like to say it is the least we can do as a country for those people. My State has lost some people, and I am sure many others have.

Again, this is the least we can do, and I compliment you for having thought of this in a timely manner.

Chairman **Stark**. Thank you very much. We appreciate your action on this.

Mr. **Archer**. Thank you.

Chairman **Stark**. We will now go back out of order and complete the business of this morning's hearing and call on Mr. Jim Nichols, the commissioner of the Minnesota Department of Agriculture, if he is still with us.

The Chair would like to note the return of the Treasury Department, I gather, bringing with him the study on the PIK program due in September and the study on the Caribbean tax havens. That study was due today.

STATEMENT OF MIKEL M. ROLLYSON, DEPUTY TAX LEGISLATIVE COUNSEL, DEPARTMENT OF THE TREASURY

Mr. **Rollyson**. I come bearing gifts, but not exactly those.

Chairman **Stark**. Do you have any idea, seriously, when—are the reports even started?

Mr. **Rollyson**. Well, there are two. With respect to the PIK program, it is very difficult for us to have any taxpayer information obviously.

Chairman **Stark**. Because agriculture does not——

Mr. **Rollyson**. No. Because payments were made in 1983, so returns will not be filed until 1984, so it will be very difficult to have any of the significant information on that.

Chairman **Stark**. How about the Caribbean tax havens? The vacation season is coming up. It is getting snowy up here, and it might come time for an inspection into Caribbean tax havens. We might need Treasury people to go along if we had the report. [Laughter.]

Mr. **Rollyson**. The nicer weather down there is very conducive to reportmaking. I have, since we last spoke 30 or 40 minutes ago, touched base with the international tax counsel, and there is some question as to exactly the due date of that report, but he assures me it is well near completion, and you should have it very shortly.

Chairman **Stark**. Thank you. Thank you very much.

You are here at this point, Mr. Rollyson to comment on H.R. 4206, and if you want to just pick up. I note that you have some interest in language changes, and if you could also comment on the practicality and possibility of including civilian Federal employees who are killed by the same sort of action.

Continue in any way you see fit.

Mr. **Rollyson**. We are here to testify on the complete list of bills. Secretary Regan has already spoken favorably, indicating our strong support for H.R. 4206. Also, Congressman Archer has, I think, addressed most of the concerns that we have expressed in our testimony regarding the scope of that proposed legislation. I certainly think it is well on its way to being a very good package, one we obviously strongly support, and I would be happy to explore the possibility of extending it as per your suggestion to certain civilian employees.

Chairman STARK. I am being very specific. We have had civilian embassy personnel killed, and we do have, although we do not often admit it, we have nonuniformed personnel sometimes in situations where hostilities do occur, and even, indeed, Members of Congress and the administration, I might add.

Do you want to just run through in your own fashion the rest of the bills?

Mr. ROLLYSON. Yes. We are running a little late today, I realize. There are a lot of bills here. I will tell you our position on each of the bills, and feel free to interrupt me and ask questions on any specific bill.

H.R. 677 would exclude from income and employment taxes the value of certain qualified campus lodging furnished by educational institutions to employees, employee spouses, and dependents. This legislation essentially would——

Chairman STARK. This is only for lodging received before 1984?

Mr. ROLLYSON. That is correct. It is designed exclusively to be retroactive legislation.

The effect of this bill is, in essence, to extend the provisions of section 119 of the Code. That section of the Code specifically excludes certain lodging provided to employees, if certain tests are met.

We oppose this legislation because we think the law has been clear with respect to the taxability of employer-provided housing for many years. The statute clearly establishes the requirements which must be met to permit the exclusion of the value of the lodging provided, and the regulations have provided, since approximately 1956, that unless those conditions are satisfied, the value of the housing must be included in income.

We think these results are proper, and therefore, we must oppose this bill.

Chairman STARK. Could I just see if I could understand this? Is it a fair assumption that the universities—it is primarily universities, maybe some boarding secondary schools—will testify that the purpose of faculty housing is to create a better educational environment, et cetera?

Is it a correct assumption that this practice has been going on since the time of Mr. Chips, and it is only in very recent years that the Service went after that ostensibly extra income?

Mr. ROLLYSON. I cannot speak to the length of time these transactions have been going on. I would suspect they have gone on for quite some time. It is not true that the Treasury or the Internal Revenue Service only recently focused on this problem. It was focused on extensively in 1954, and in 1954 there was an effort made to promulgate clear rules as to when the lodging would be includable or excludable from income.

The regulations have clearly addressed this since 1956, so it is not a recent phenomenon.

Chairman STARK. I have a sneaking hunch that just looking at some of the witnesses who are about to appear in favor of the bill that there is a certain area tilt to this, a regional tilt, and that that is a result of some recent, in the past 4 or 5 years, either audit or collection procedures. Is that true?

Mr. ROLLYSON. There have been several audits in recent years in which the Internal Revenue Service has imposed or has proposed tax liabilities with respect to institutions for failure to withhold. I do not know to what extent——

Chairman STARK. I guess what I am trying to get at is this: was there some rule writing done in the middle fifties that was then shoved on the back burner for a few years, but reveiwed suddenly in the past 4 or 5 years with a little flurry of activity that caught a lot of people unawares?

Mr. ROLLYSON. I do not know the degree of activity in the interim there, but there is case law dealing with this which arose in the interim.

Chairman STARK. Mr. Shannon is finally here, and it is his bill. I will let him hustle for it.

Mr. ROLLYSON. He is in the wings.

Chairman STARK. Go ahead and proceed.

Mr. ROLLYSON. H.R. 1607 would guarantee lease treatment to certain motor vehicle operating agreements by requiring that terminal rental adjustment clauses, better known as TRAC clauses, be ignored in determining whether the agreements are indeed leases or whether they constitute conditional sales.

To understand the impact of this proposed bill, one must understand the nature of a TRAC clause in a typical motor vehicle lease. Most motor vehicle leases fall into one of two categories. They are either open end leases or closed end leases.

In an open end lease the property would be leased for a 2 to 3 year period, rents would be paid during that period, and the lessee, the user of the automobile would pay all maintenance repair costs traditionally associated with the lease, plus any cost imposed upon the dealer with respect to licenses, fees, taxes, et cetera.

Importantly, an open end lease would contain a TRAC clause. The nature of a TRAC clause is essentially that at the end of the lease the putative lessor and lessee agree that the property will have a stipulated value equal to its blue book value, and at the end of the lease term if the automobile cannot be sold for that blue book value, then the user of the auto has to make up the difference. That is a critical feature, because the effect of that provision is to impose the risk of loss with respect to any decline in value of the automobile on the user of the automobile.

When you combine the risk of loss with the other incidence of ownership in the user of the automobile, we think it is relatively clear, and in fact, case law so holds that an open-end lease with a TRAC clause should be treated as the sale of an automobile to the user. Therefore, the user should be treated as the owner of the automobile.

This is particularly important because for tax purposes the tax owner of the automobile is the one to whom depreciation deductions and investment tax credit deductions flow.

A closed-end lease does not typically have a TRAC clause. Therefore, in a closed end lease, the lessor bears the burden or risk of loss with respect to declines in value. Therefore, he would be treated as the owner of the automobile.

Chairman STARK. Go ahead.

Mr. ROLLYSON. We oppose this proposed bill because it would, in effect, single out the motor vehicle industry for treatment much akin to safe harbor leasing. The Treasury Department does not necessarily oppose permitting the transferability of tax benefits. We have testified favorably with respect to those transfers of tax benefits in the past. Nevertheless, we do oppose targeting that transferrability to one specific industry while denying it to all other industries.

Chairman STARK. Is it not a fact that in TEFRA—and I believe I was a conferee, as was my distinguished colleague from Tennessee—that all we did was make this bill retroactive to take the auto leasers off the hook, but that there was nothing in TEFRA—I have the report here—and nothing in the conference report on the bill that was ever intended to apply this prospectively to the auto industry? Is that not your understanding?

Mr. ROLLYSON. That is correct, Mr. Chairman. The TEFRA legislation simply says that a TRAC clause will be ignored until we issue regulations, and that makes it perfectly clear that we do have the authority to issue regulations under which a TRAC clause provision might treat the owner, might deem the user of the vehicle to be the owner.

Chairman STARK. Are there revenue estimates of how this would work if it were applied across the board as opposed to automobiles only?

Mr. ROLLYSON. I do not have such an estimate.

Chairman STARK. Do you know if there are?

Mr. ROLLYSON. I do not know. I would be happy to find out.

Chairman STARK. Does Joint Committee have those estimates?

[No response.]

Chairman STARK. All right. Proceed.

Mr. ROLLYSON. H.R. 2568 would eliminate the 1984 sunset of Section 127 of the Code which provides for the exclusion from gross income of certain amounts received under educational assistance programs.

Section 127 excludes from gross income these amounts for educational assistance if certain conditions are satisfied. I will be rather brief here.

Treasury opposed section 127 when it was enacted on the grounds that these benefits should be subject to tax. Simply by the fact that the benefits are chosen by an employer should not result in those benefits being excludable from income. And we continue to oppose H.R. 2568 on the same grounds.

H.R. 3030 would provide that certain unemployment compensation paid to certain employees during 1979 would be excluded from the gross income of those employees. Presently—well, prior to the enactment of section 85 of the Code, it was clear that Government-provided unemployment benefits were excluded from gross income. There was a longstanding administrative practice of the Internal Revenue Service that that was the result.

Section 85 was enacted to require that amounts be included in gross income where they are in excess of a certain base amount when added to a taxpayer's adjusted gross income.

Treasury supported that provision and continues to support that notion because these benefits essentially replace taxable wages or taxable unemployment compensation benefits.

Moreover, this particular piece of legislation was targeted to benefit approximately 1,400 employees of Sun Oil Co., and we do not see why this particular legislation should be singled out for this particular group. Therefore, we do oppose this provision.

H.R. 3529 would make certain amendments to the provisions of the Code relating to the taxation of regulated investment companies. The taxation of these companies is somewhat complex, but I would like to say just a word or two about these provisions.

By and large we support the proposed changes to H.R. 3529. Section 1 of the bill would permit a personal holding company to elect RIC status, notwithstanding that under current law, personal holding companies are precluded from making such an election.

In light of certain recent legislation involving subchapter S corporations, we think this prohibition is no longer necessary, particularly when it would be backstopped with a provision requiring that certain undistributed income of the RIC be taxed at the personal holding company rates.

There is one provison of H.R. 3529 which merits a little further comment. It would preclude a regulated investment company—excuse me—it would preclude a personal holding company from electing to be taxed as a regulated investment company if the personal holding company has accumulated earnings and profits.

We favor this rule. However, we would suggest that this rule be extended to all companies which are planning to elect to be taxed as a regulated investment company. Without such a safeguard it is possible that companies with accumulated earnings and profits will not pay what is deemed to be an appropriate amount of tax with respect to their accumulated earnings.

Permitting such an election would provide an incentive for making the RIC election without distributing those accumulated earnings and profits.

H.R. 4271 would increase the limitation on the deduction for business gifts from the current $25 level to a $100 level. We do not oppose this change. It has been 20 years since the limitation on business gifts has been changed. We think it is appropriate at this time that there be some increase in the $25 level. We are continuing to explore the revenue implications of that increase, but we do think that some increase is appropriate at this time.

H.R. 4253 would allow certain deductions for transportation and traveling expenditures incurred by certain employees traveling to a temporary jobsite after 1969 and before 1975. Obviously, this is legislation targeted at a particular group of employees employed at a missile site at North Dakota during those periods of time.

We oppose this targeted legislation. The bill would be designed to make all travel and transportation expenses of these employees fully deductible without regard to the facts and circumstances surrounding the individual taxpayers involved.

Whether taxpayers are allowed travel and transportation expenses for such job-related expenses is a factual question. It is one which the Service and Treasury Department have been actively exploring.

There was a ruling issued by the Internal Revenue Service in 1983 attempting to clarify the deductibility of certain of these expenses, plus there is an active regulation project under way at the Treasury Department where we would try to clarify further the tax treatment of these expenses.

Chairman STARK. Mike, is it not a fact in this particular instance you lost in court?

Mr. ROLLYSON. There has been a court case in which a taxpayer was successful in having deductions allowed with respect to certain travel and transportation expenses. However, Mr. Chairman, that does not mean that all taxpayers who were employed at that jobsite would have the same factual circumstances as that employee; therefore, it is not proper to say that all employees should be entitled to the deduction.

Chairman STARK. We will get you back to that, and Mr. Dorgan will have his shot at you in a moment.

Mr. ROLLYSON. Yes, I am sure he will.

Chairman STARK. Do you want to repeat your feeling on H.R. 4253? That will save us some time.

Mr. ROLLYSON. Do you want me to read the record back?

Chairman STARK. No. Just briefly explain why.

Mr. ROLLYSON. Congressman Dorgan, we oppose H.R. 4253 on the grounds that it does target the deductibility of these expenses to a particular group of employees without any consideration of the particular factual circumstances surrounding those employees. And, as I mentioned before you arrived, as you well know, there has been a revenue ruling issued by the Internal Revenue Service which attempts to clarify some of the issues surrounding these questions, plus the Treasury Department does have an active regulation project under way where we would hope to clarify these issues further.

That concludes my statement. I would be happy to answer any questions.

[The prepared statement follows:]

STATEMENT OF MIKEL M. ROLLYSON, DEPUTY TAX LEGISLATIVE COUNSEL, DEPARTMENT OF THE TREASURY

Mr. Chairman and Members of the Subcommittee, I am pleased to present the views of the Treasury Department on the following bills:

H.R. 677, which would exclude from the income and employment taxes of the Code the value of qualified campus lodging furnished by an educational institution to any employee, employee's spouse or employee's dependent.

H.R. 1607, which would guarantee lease treatment to certain motor vehicle operating agreements by requiring that terminal rental adjustment clauses be ignored in determining whether the agreements are leases or conditional sales.

H.R. 2568, which would eliminate the 1984 sunset of section 127 of the Code which provides for the exclusion from gross income of amounts received under certain educational assistance programs.

H.R. 3030, which would provide that certain unemployment compensation paid to certain employees during 1979 would be excluded from the gross income of those employees.

H.R. 3529, which would make certain amendments to the provisions of the Code relating to the taxation of regulated investment companies.

H.R. 4271, which would increase the limitation on the deduction for business gifts from $25 to $100.

H.R. 4253, which would allow deductions for certain transportation and traveling expenditures incurred by certain taxpayers after 1969 and before 1975.

H.R. 4206, which would exempt from income tax certain income of members of the United States Armed Forces who die as a result of hostile actions overseas.

I will discuss each bill in turn.

H.R. 677

RETROACTIVE INCOME AND EMPLOYMENT TAX EXCLUSION FOR VALUE OF CERTAIN FACULTY HOUSING

BACKGROUND

The value of lodging furnished by an employer to an employee, his spouse, or any of his dependents is excluded, under section 119 of the Code, from the employee's income if three tests are met: (1) the lodging is furnished on the business premises of the employer, (2) the lodging is furnished for the convenience of the employer, and (3) the employee is required to accept the lodging as a condition of his employment. Congress enacted section 119 as part of the Internal Revenue Code of 1954 in order to end confusion as to the tax status of meals and lodging furnished to an employee by his employer.

When these three tests are met, the exclusion applies irrespective of whether a charge is made for the lodging or whether, under an employment contract or statute fixing the terms of employment, such lodging is furnished as compensation. If these three tests are not met, the regulations under section 119 require that the employee include in gross income the value of the lodging.

Section 3401(a) of the Code, relating to withholding of income taxes from wages, provides that the term "wages" means all remuneration for services performed by an employee, including the cash value of all remuneration paid in any medium other than cash, unless specifically excepted. The regulations under section 3401 specifically exempt from withholding the value of any meals or lodging furnished to an employee that is excludable from income under section 119.

Wages, for purposes of FICA and FUTA taxes, also are defined to include the value of all remuneration paid in any medium other than cash. Prior to 1983, no statutory or regulatory exception to this general rule existed for lodging, whether or not the lodging was excluded from income under section 119.

H.R. 677

H.R. 677 would provide that the income and employment tax provisions of the Code be applied without regard to the value of qualified campus lodging furnished by an educational institution to any employee or to any spouse or dependent of any employee. Qualified campus lodging is defined as lodging which is located on a campus of, or in the proximity of, the educational institution and for which the institution receives a reasonable rent which is not less than the necessary direct costs paid or incurred by the institution in providing the lodging.

The determination of whether the rent charged is a reasonable rent is to take into account such factors as the necessary direct costs of the institution furnishing the lodging, the value of the lodging to the employee to whom it is furnished, and any educational purposes of the institution in furnishing such lodging. The rent charged is not precluded from being treated as reasonable solely because it is less than the fair rental value of the lodging provided. In any case in which lodging is treated as qualified campus lodging but for the fact that the rent received is less than the necessary direct costs of the institution, only the excess of the necessary direct costs over the rent received is taken into account for income and employment tax purposes.

The bill would be effective for taxable years or periods beginning before January 1, 1984.

DISCUSSION

The Treasury Department believes that it has been clear since the enactment of section 119 that the value of employer-furnished lodging that does not meet the requirements of that section is includible in income for income tax purposes and in wages for withholding and employment tax purposes. Therefore, we oppose retroactively exempting the value of such lodging from these provisions of the Code.

Lodging provided to employees primarily as compensation has been treated consistently as income for purposes of the income tax provisions and wages for purposes of the withholding and employment tax provisions of the Code. Experience prior to the enactment of section 119 demonstrated that it was often very difficult to determine whether lodging was provided to an employee primarily to enable the employee to perform his duties or primarily to provide compensation. The conditions for exclusion under section 119 represent an attempt to establish objective standards by which the exclusion will be limited to those situations in which lodging is provided primarily to enable the employee to perform his job.

The Treasury Department believes that section 119, as interpreted by the courts, has substantially achieved the objective of ending confusion as to the tax status of lodging furnished to an employee by his employer. The regulations under section 119 have stated since 1956 that the value of lodging that fails to satisfy the criteria for exclusion under section 119 is to be included in income. This rule has been applied by the courts in a number of cases, including cases involving faculty housing provided by educational institutions. *Goldsboro Christian Schools, Inc.* v. *United States,* 436 F. Supp. 1314 (E.D.N.C. 1977), motion for reconsideration denied, 79-1 U.S.T.C. ¶9266 (E.D.N.C. 1978), aff'd in unpublished opinion (4th Cir., 1981); *Bob Jones University* v. *United States,* 670 F.2d 167 (Ct. Cl. 1982).

Similarly, withholding tax regulations have consistently required that, if employee services are paid for in a medium other than cash, "the fair market value of the thing taken in payment is the amount to be included as wages." Treasury Reg. §31.3401(a)-1(a)(4). An exception to this general requirement is provided for meals and lodging furnished to an employee "if the value of the meals or lodging is excludable from the gross income of the employee." Treasury Reg. §31.3401(a)-1(b)(9). This exception is followed by a cross reference to the regulations under section 119. In *Goldsboro Christian Schools, Inc.* v. *United States,* 79-1 U.S.T.C. ¶9266 (E.D.N.C. 1978), the court stated that "the law applicable here—that free lodging is subject to the withholding tax, absent a convenience of the employer' purpose—has been consistent and settled since at least 1944."

With respect to the treatment of lodging for purposes of FICA and FUTA taxes, wages of all remuneration paid in any medium other than cash, except as specifically provided otherwise. Prior to enactment of the Social Security Amendments of 1983, no statutory or regulatory exception to this general rule was provided, and the value of lodging was generally subject to FICA and FUTA taxes, even if the value of the lodging was excluded from income and not subject to income tax withholding by reason of section 119. Although this rule was recently modified to exclude from wages for FICA and FUTA purposes the value of meals or lodging that is excluded from income under section 119, it remains clear that the value of lodging that cannot reasonably be expected to be excluded from income under section 119 is included in wages for FICA and FUTA purposes.

Thus, the tax law in this area is relatively clear. We believe that it would erode the effectiveness of the income tax system if the taxation of employer-furnished lodging were changed retroactively.

In addition to our basic objection to H.R. 677, we also have some technical concerns about the bill as drafted. In particular, the bill eliminates fair rental value as a standard without substituting any other standard for determining whether rent paid for lodging meets the requirement that a reasonable rent be charged. We believe it would be extremely difficult to apply this provision without further clarification of the meaning of reasonable rent.

We also note that the bill would exempt the value of lodging from FICA taxes but makes no provision for eliminating the value of such lodging from the Social Security benefit base. Thus, enactment of H.R. 677 would result in the payment of Social Security benefits based on the value of lodging with respect to which no FICA tax has been paid.

H.R. 1607

GUARANTEE OF LEASE TREATMENT FOR CERTAIN MOTOR VEHICLE OPERATING AGREEMENTS

BACKGROUND

There are two basic types of motor vehicle operating agreements—"closed end" and "open end". In a typical open end agreement, a provider of vehicles, for example an automobile dealership, agrees to acquire a certain make and model of vehicle for use by its customer. The agreement generally has a term of 24 to 36 months. Under the agreement, the customer performs all necessary maintenance and repairs to the vehicle and pays the dealer a monthly charge sufficient to cover the expected economic depreciation on the vehicle, insurance in favor of the dealer, license and registration fees, sales taxes, and any other miscellaneous costs imposed upon the dealer. An open end agreement also contains a provision known as a "terminal rental adjustment clause."

A terminal rental adjustment clause ("TRAC clause") in the usual case will provide that the vehicle subject to the agreement is to be sold (or offered for sale) to a third party. If the proceeds from this sale are less than an estimate of the value of the vehicle as stipulated in the agreement (which is generally the projected "blue book" value of the vehicle on the termination date of the agreement), the customer is obligated to pay the difference to the dealer. If the sale proceeds equal the stipulated value, no further payment is due. Finally, the agreement will provide either that the dealer will retain any excess of the sale proceeds over the stipulated value or that the dealer must remit the excess to the customer, directly with a cash refund or indirectly by crediting the customer's payments under a new agreement.

A closed end agreement differs from an open end agreement in one important respect. Unlike an open end agreement, closed end agreements do not contain TRAC clauses. Thus, the dealer under a closed end agreement bears the risk that the value of the vehicle at the normal end of the agreement will be less than its projected value.

Prior to the Tax Equity and Fiscal Responsibility Act of 1982 ("TEFRA"), the status for Federal tax purposes of a motor vehicle operating agreement either as a lease, a loan, or a conditional sale, was determined from all the facts and circumstances. Whether an agreement is a lease or a sale is important because it determines which party—the dealer or the customer—is the owner of the vehicle for Federal tax purposes and thus is entitled to claim depreciation and the investment tax credit with respect to the vehicle.

If an agreement is considered a lease for Federal tax purposes, then the dealer, as a lessor, is entitled to claim the tax benefits associated with the vehicle and must report the periodic payments it receives from the customer as rental income. On the other hand, if an agreement is treated as a loan or a conditional sale, the customer is considered the tax owner of the property. The customer is then entitled to claim depreciation and the investment credit with respect to the vehicle if it is used in a trade or business and may deduct any interest expense that is part of the financing transaction.

In 1979 the Internal Revenue Service issued a technical advice memorandum in which it concluded that a standard open end motor vehicle operating agreement was a conditional sale and not a lease. This position was ultimately sustained in the case of *Swift Dodge* v. *Commissioner,* 692 F.2d 651 (9th Cir. 1982), *rev'g* 76 T.C. 547 (1981), where the Court of Appeals for the Ninth Circuit found that there were "no essential differences between [the transactions under review] and a conditional installment sale with a lump sum final payment."

Between the time of the Tax Court's decision in *Swift Dodge* and the Ninth Circuit's reversal, Congress enacted section 210 of TEFRA. That section generally provides that until the Treasury Department publishes a regulation stating that an agreement containing a TRAC clause is not a lease for Federal tax purposes, the existence of a TRAC clause is not to be taken into account in deciding whether such an agreement is a lease. This provision essentially guarantees lease treatment for open end motor vehicle agreements entered into before a regulation is published. Under the TEFRA provision, the guarantee of lease treatment applies only if the lessee uses the property in a trade or business or for the production of income.

On November 23, 1982, the Treasury Department published a proposed regulation that would deny lease treatment to motor vehicle operating agreements with TRAC clauses. A public hearing on the regulation was held on February 10, 1983. A final regulation has not yet been published.

H.R. 1607

H.R. 1607 would continue permanently the guarantee of lease treatment to open end motor vehicle operating agreements by requiring that terminal rental adjustment clauses be ignored in determining whether the agreements are leases. H.R. 1607 also would extend lease treatment to open end agreements with cutomers that use the vehicles for nonbusiness, personal purposes. The term "motor vehicle" is not defined.

DISCUSSION

The Treasury Department opposes the enactment of H.R. 1607. In our view, open end leases are conditional sales for tax purposes. While the Treasury has, in the last two years, supported leasing as an efficient means for transferring tax benefits, we see no justification for favoring motor vehicles over other equipment that is often leased, such as railroad boxcars, ships, and airplanes.

Open end leasing efficiently transfers tax benefits because the price paid by the lessee reflects the fact that the lessor is insulated against any decline in the value of the leased property. The only risk borne by a dealer under a motor vehicle agreement containing a TRAC clause is the risk that the customer will default on its obligation under the agreement. However, as correctly observed by the Ninth Circuit in the *Swift Dodge* case, this risk is exactly the same as the risk assumed by a lender making a loan secured by property to one of its customers. In such a case, the law is clear that the lender is not the owner of the property for tax purposes.

As the controversy over safe harbor leasing has highlighted, there is a tension between the economic theory favoring free transferability of tax benefits and the traditional tax rule that substance should govern over form. Congress has addressed this issue both in 1981 and in 1982. Safe harbor leasing, enacted in the Economic Recovery Tax Act of 1981, allowed lessors to be treated as owners of leased property for Federal tax purposes under certain agreements that would not have been characterized as leases previously. Under TEFRA in 1982, safe harbor leasing was repealed generally beginning in 1984 and was restricted in the interim. In its place, Congress substituted special rules relating to certain finance leases, which adhere much more closely to the leasing rules applicable prior to safe harbor leasing.

In the leasing amendments made by TEFRA, Congress specifically recognized that the Treasury could promulgate regulations concerning TRAC clauses and their effect on the characterization of motor vehicle operating agreements. In context, section 210 of TEFRA was part of larger changes in the leasing area, all of which limited the transferability of tax benefits by requiring leases to contain traditional lease characteristics. We agree with the decision of the Ninth Circuit in *Swift Dodge* that when the terms of open end leases are closely scrutinized, it is clear that they are not leases. Any argument that open end leases should be treated as leases and not as conditional sales must, therefore, rest on other factors.

Since publication of the proposed regulations, we have carefully considered the major arguments advanced by the motor vehicle lessors for treating open end agreements as leases. In our deliberations, we have reached the conclusion that these arguments do not justify giving the motor vehicle leasing industry preferential treatment over other lessors.

The first argument made by the industry is that open end leases lower the cost of the property to the customer. This assertion is not necessarily true. In a true lease, the customer compensates the lessor for assuming the risk that the property will go down in value. In an open end lease, the customer assumes that risk, so the customer does not pay the lessor for it. Because of the customer's assumption of risk, the stream of "rents" under a TRAC lease is less than those under a true lease. However, because the customer bears the risk of loss, the total cost of the property to the customer will not necessarily be reduced; if the value of the property declines below the estimated value, the loss, when added to the rents, may exceed the cost to the customer under a closed end agreement.

A second point made by the industry is that open end agreements are not motivated by tax avoidance and that both parties to these agreements have consistently treated the transactions as leases. They argue that the IRS has not been whipsawed by the parties' taking inconsistent positions. On this point, there is little evidence. A dealer would not know how its customers reported the transaction without examining each customer's tax return. Even if consistent positions are always taken, however, transactions between business taxpayers may be motivated by tax considerations if the tax benefits of ownership are less valuable to the customer than to the lessor.

Next, the industry justifies a special exception for motor vehicles on the grounds that the tax treatment of open end agreements is long established and that the practice in the industry was tacitly approved by IRS and Treasury. This is simply not true. Prior to 1979 the Service's position with respect to these agreements may not have been articulated in a published ruling. However, records of past meetings between the Treasury, the IRS, and representatives of the motor vehicle leasing industry show that strong reservations were expressed by IRS and Treasury personnel about whether open end agreements were leases. Members of the industry have proceeded in the face of those warnings. Any hardship that might occur by disrupting past transactions was resolved in TEFRA. For the future, the industry should have to comply with the same set of rules that govern the airlines, the steel industry, the paper companies, the mining industry, and other industries, all of which would greatly appreciate the opportunity to use open end agreements with impunity.

We have no doubt that final regulations will change the business practices of the motor vehicle leasing industry, and we recognize that there could be some disruptions in the short run as the industry adjusts to the rules in the regulation. But if the dealers in fact provide valuable services to their customers (other than merely providing financing for the vehicle), that business will continue in an altered form. In any case, the tax incentives provided by the investment credit and ACRS will continue to be available when vehicles are used for business purposes.

Finally we note that H.R. 1607 would extend lease treatment to open end operating agreements with respect to vehicles that are not used in a trade or business or for the production of income. In this situation, the investment credit and accelerated cost recovery allowances would not be available if the transaction were cast as a conditional sale so that the customer is considered the owner of the vehicle for tax purposes. The investment tax credit and ACRS deductions are subsidies intended for business property. We would object strongly to extending these tax benefits to financing transactions involving vehicles used for personal purposes.

Let me emphasize that we are not opposed to statutory rules that would improve the efficiency of transferring tax benefits. What we oppose is the special status that H.R. 1607 would confer upon the motor vehicle leasing industry relative to other industries. We think that it is impossible to draw this line with any justification.

H.R. 2568

Extension of Tax-Free Educational Assistance Programs

BACKGROUND

Effective for taxable years beginning after 1978 and before 1984, section 127 of the Internal Revenue Code provides an exclusion from an employee's gross income for educational assistance furnished by an employer under a qualified educational assistance program. In order to qualify for this exclusion, the program must meet a number of requirements. First, the educational assistance must be provided for the exclusive benefit of employees. Second, the courses offered cannot involve sports, games, or hobbies, nor can the program reimburse employees for meals, lodging, or transportation expenses. Third, the educational benefits cannot be offered under a "cafeteria" plan that gives the employee an option to receive, as an alternative to educational benefits, other remuneration which is includible in gross income. Finally, the clasification of employees eligible for benefits must not discriminate in favor of officers, owners or highly compensated employees. Although program utilization rates will not cause a program to be disqualified for discrimination, no more than 5 percent of plan benefits can be paid to owners of more than 5 percent of the business (or to their spouses or dependents).

Code section 127 was enacted in 1978 in order to enlarge the ability of employers to provide tax-free educational assistance to their employees. Prior to the enactment of section 127, the Service had ruled that employees could exclude from income the value of educational assistance provided by employers through either direct payments to educational institutions or in-house educational programs, if the courses of instruction were limited to job-related subjects that would improve or maintain an employee's skills. Any educational assistance payments made directly to an employee were required to be included in gross income (unless the payments qualified as a scholarship or fellowship under section 117). Once such payments were included in income, the employee could deduct the educational expenses as business expenses under section 162, provided that he could establish that the expenses were for "job-related" education. Job-related education was defined as education that (1) maintains or improves skills required in the individual's employment or (2) meets the employer's express conditions as to the employee's retention of his job, job status, or rate of compensation. No deduction was permitted for personal expenditures for education that would qualify the employee for another trade or business.

By enacting section 127 in 1978, Congress eliminated the need to distinguish on a case-by-case basis between "job-related" and "personal" education whenever either cash payments or educational courses are provided to employees under qualified educational assistance programs. Treasury opposed the enactment of section 127 in 1978, on grounds that equity requires that compensation received in the form of educational benefits (whether paid in kind or in cash) should be taxed the same as any other type of compensation received by employees. The Treasury statement noted that any exemption for certain types of income only encourages employees to rearrange their affairs so that compensation is received in a non-taxable form. Treasury also pointed out that any problems with the rules under section 162 for deducting educational expenses should be addressed directly by modifying those rules for all taxpayers rather than by creating a special exclusion from gross income for employer-provided educational benefits.

H.R. 2568

H.R. 2568 would eliminate the 1984 sunset of section 127 and extend the provision permanently. The bill would not make any amendments to the existing statutory protections against abusive operation of these educational assistance plans.

DISCUSSION

The Treasury Department opposes H.R. 2568 for the same reasons we opposed the enactment of section 127 in 1978. The rules under section 162 governing deductibility of educational expenses should be applied equally to all individuals. The regulatory "job-related" test can never be replaced adequately by any set of statutory rules which exempt certain educational benefits simply because they are paid for by an employer.

We wish to note that while the bill has been described as one primarily designed "to encourage the self-improvement on a non-discriminatory basis of women, members of minority groups, and unskilled workers," taxpayers with the highest incomes will receive the greatest benefits from the income exclusion.

H.R. 3030

Exclusion for Certain Unemployment Compensation Paid in 1979

BACKGROUND

Effective for taxable years beginning after 1978, section 85 of the Code provides that a portion of unemployment compensation benefits paid under government programs must be included in the adjusted gross income of any recipients who have substantial other income during the year. The amount of unemployment compensation included in income is limited to one-half of the excess of (a) the sum of the taxpayer's adjusted gross income, all unemployment compensation paid pursuant to government programs, and all excludible disability income, over (b) the taxpayer's "base amount." This base amount was $25,000 from 1979 through 1981 ($18,000 after 1981) in the case of a married individual filing a joint return; zero in the case of a married individual filing a separate return (unless he or she or she lived apart from his or her spouse thoughout the year); and $20,000 from 1979 through 1981 ($12,000 after 1981) in the case of all other individuals.

Section 85 was enacted because Congress believed that unemployment compensation paid under government programs is in essence a substitute for taxable wages and is equivalent to employer-funded unemployment benefits paid under private plans (which are includible in gross income). The provision overrode a series of revenue rulings dating from 1938, which generally excluded unemployment compensation from gross income. Section 85 was applied to all payments of unemployment compensation made after 1978, irrespective of whether the benefits may have been attributable to periods of unemployment before the provision took effect.

H.R. 3030

H.R. 3030 would amend the effective date of section 85 to exempt certain unemployment compensation (1) paid by reason of a work stoppage which began on March 19, 1973, and ended before July 19, 1973, and (2) paid in 1979 after the employer's appeal to the U.S. Supreme Court was dismissed on April 2, 1979, and its petition for rehearing was denied on May 21, 1979. The bill also would allow recipients of the benefits covered by the bill to file claims for credit or refund of taxes paid on their 1979 unemployment benefits within one year after the date of enactment, despite the fact that such claims otherwise might be barred.

We understand that the intended beneficiaries of H.R. 3030 are approximately 1,400 individuals represented or formerly represented in collective bargaining by Local (8)-901 of the Oil, Chemical and Atomic Workers International Union, located in Marcus Hook, Pennsylvania. These individuals were out of work between March 19 and July 19, 1973, due to a lockout in a dispute between their union and their employer, the Sun Oil Company of Pennsylvania. Payment of their unemployment compensation benefits was delayed until 1979 because of protracted litigation on the issue of whether benefits could be granted to locked-out employees, but denied to striking employees. (See *Unemployment Compensation Board of Review of Common-*

wealth of Pennsylvania v. *Sun Oil Co. of Pennsylvania,* 476 Pa. 589 (1978), cert. denied, 440 U.S. 977, rehearing denied, 441 U.S. 968 (1979).)

DISCUSSION

The Treasury Department opposes H.R. 3030. The bill would grant relief only to those employees of the Sun Oil Company who were granted unemployment benefits in 1979 attributable to a work stoppage in 1973. The bill thereby places at a significant disadvantage any other individuals who received unemployment compensation after 1978 for periods of unemployment prior to 1979. We oppose singling out one group of employees for a special exemption from Congress's determination in 1978 (which was implemented through section 85) that governmental unemployment benefits are equivalent to wages or employer-funded unemployment benefits, and therefore should be includible in wages when paid.

H.R. 3529

MISCELLANEOUS AMENDMENTS RELATING TO REGULATED INVESTMENT COMPANIES

H.R. 3529 makes certain amendments to the provisions of the Internal Revenue Code relating to regulated investment companies ("RICs"). Treasury supports sections 2 and 3 of H.R. 3529. Treasury also supports section 1 of the bill, although we believe that section 1(c) should be given broader application than it has under the bill as presently drafted.

SECTION 1

Section 1(a) would remove the prohibition against a personal holding company ("PHC") electing to be a RIC (the "PHC prohibition"). Section 1(b) would subject RICs that are PHCs to tax at the highest corporate tax rate on their undistributed earnings. Section 1(c) prevents a PHC from qualifying as a RIC for tax purposes if it has accumulated earnings and profits from a prior taxable year in which it was not a RIC. The limitation of section 1(c) would not apply to any RIC that has qualified for tax purposes for all taxable years ending on or after June 30, 1983.

Treasury supports the thrust of section 1. The principal objective of section 1 is to remove the PHC prohibition from the RIC statute. The prohibition serves little purpose, but imposes significant administrative burdens on some RICs by requiring them to monitor their possible PHC status.

The existing PHC prohibition apparently was intended to serve two functions: to insure that flow-through tax treatment of investment income is limited to widely held investment companies, and to prevent use of a RIC as an "incorporated pocketbook" that earns passive income taxed at the corporate level rather than to the shareholders. With respect to the first of these purposes, however, it is important to recognize that since enactment of the Subchapter S Revision Act of 1982, qualifying S corporations (which are closely held) generally are allowed flow-through tax treatment for their investment income without limitation as long as they have no accumulated earnings and profits from years in which they were Subchapter C corporations. Since S corporations need not be widely held to benefit from flow-through taxation of their investment income, we know of no reason why a similarly situated RIC (another form of flow-through entity) should be treated differently.

With respect to the second purpose of the PHC prohibition, section 1(b) of the bill imposes a tax at the highest corporate tax rate (46 percent) on a RIC's undistributed earnings if it is a PHC. This tax, in addition to the PHC tax to which such a RIC also would be subject, is adequate to discourage use of RICs to avoid tax on their shareholders with respect to undistributed passive investment income.

Section 1(c) would prohibit a PHC from becoming a RIC if it has accumulated earnings and profits from a non-RIC year. Section 1(c) reflects a concern similar to that which motivated Congress to include in the Subchapter S Revision Act special limitations applicable to S corporations with Subchapter C accumulated earnings and profits. In the absence of these limitations, a large number of C corporations with active businesses and substantial accumulated earnings might sell their business assets, make S corporation or RIC elections, invest the proceeds in passive investments, and distribute the investment earnings without payment of corporate-level taxes. There would be little reason for a corporation in this case to pay dividends out of its accumulated earnings from the discontinued business, or to liquidate the corporation and subject the shareholders to tax on the liquidation. This could result in a large volume of tax-motivated sales of businesses and a substantial reduction in income tax revenues from corporations and their shareholders.

We believe that the policy of section 1(c) is sound, but that it logically cannot be limited to RICs that are PHCs. Any corporation (whether or not a PHC) that has accumulated earnings and profits could obtain undue tax benefits from a RIC election. Treasury believes that section 1(c) should be extended to cover all corporations desiring to become RICs, not just PHCs that seek RIC status. We would not object to grandfathering all existing RICs from this rule, and providing reasonable rules to deal with RICs that inadvertently lose their RIC status and wish to re-establish RIC status in the following year.

In summary, Treasury does not oppose sections 1(a) and 1(b) of the bill. However, Treasury believes that section 1(c) should be extended to cover all corporations desiring to become RICs, not just PHCs.

SECTION 2

Section 2 would permit RICs to elect to compute their taxable income with respect to short-term government obligations issued at a discount without regard to Code section 454(b). Code section 454(b) states that discount on certain short-term government obligations having a maturity of 1 year or less accrues for tax purposes when the obligations are paid at maturity, sold, or otherwise disposed of. Treasury supports section 2.

We understand that money market RICs accrue interest on debt obligations daily for bookkeeping and SEC purposes, and that discount income on short-term government obligations issued at a discount is accrued ratably each day the obligations are held by the RIC. The disparity between the accounting treatment of this discount income (daily accrual) and the Code section 454(b) treatment (accrual on the date of maturity or sale) can create serious tax problems for a RIC that has made distributions of income based on its book income, rather than on its income determined under the rules of Code section 454(b).

The legislative history of Code section 454(b) indicates that it was enacted to relieve taxpayers of certain burdensome calculations that would be necessary if the discount on short-term government bonds were accrued on a daily basis. However, RICs must make these daily calculations for book purposes. We believe that section 454(b) was enacted for practical reasons, rather than because of any defect in the rules relating to daily accrual of discount on short-term government bonds. Thus, for a RIC that would not be burdened by the daily accrual method, Treasury does not oppose providing an election to use the daily accrual method for the class of obligations subject to Code section 454(b).

SECTION 3

Section 3 would clarify that the order in which the President signed two bills enacted by Congress in 1982 is not to be construed as having resulted in a repeal of Code section 103(m) (relating to obligations exempt from tax under provisions of law other than the Internal Revenue Code). This change also would be made by section 622(b) of the Tax Reform Act of 1983 (H.R. 4170), as reported by the Ways and Means Committee on October 21. Section 3 is merely a clarification of Congressional intent. It is clear that Congress in fact did not intend to repeal Code section 103(m) by virtue of anything contained in the second of the two bills signed by the President. Accordingly, Treasury does not oppose section 3 of H.R. 3529.

H.R. 4271

INCREASED DEDUCTION FOR BUSINESS GIFTS

BACKGROUND

Section 274(b) currently limits to $25 the amount which may be claimed as a business deduction for gifts made to the same individual by the taxpayer in one taxable year. The limitation applies only where the gift qualifies for exclusion from the recipient's gross income under Section 102.

H.R. 4271

H.R. 4271 raises the annual limitation on the deductibility of gifts to an individual in a taxable year to $100. The bill does not change existing law as to whether any item constitutes taxable income or a gift.

DISCUSSION

The annual limitation currently in effect on the deductibility of business gifts to an individual was established in 1962. The Treasury Department believes it is appropriate to limit the deduction of such business expenses where the recipient does not include in income the amounts received. Nevertheless, the $25 limitation has been eroded by inflation during the twenty years since its enactment, and we believe that some increase in the limitation is appropriate.

H.R. 4253

TRANSPORTATION EXPENSES INCURRED WITH RESPECT TO EMPLOYMENT AT THE ANTI-BALLISTIC MISSILE SITE NEAR NEKOMA, N. DAK.

BACKGROUND

In general, a taxpayer is allowed a deduction for ordinary and necessary expenses paid or incurred in carrying on a trade or business. No deduction is allowed, however, for personal, living, or family expenses, including the cost of commuting to and from work. Difficulties have arisen in delineating between transportation and travel expenses which are considered to be nondeductible personal commuting expenses and other transportation and travel expenses which are deductible business expenses.

In 1953, the Service ruled that daily transportation costs incurred by a taxpayer in traveling from the metropolitan area in which the taxpayer was regularly employed to a temporary job site outside the metropolitan area were deductible business expenses. In 1971, however, the Tax Court held that daily transportation costs were nondeductible regardless of the temporary nature of the employment or the distance traveled. The Service formally adopted the Tax Court's rationale in 1976. Subsequently, Congress required that the application of the income tax, FICA, FUTA and withholding provisions relating to the treatment of expenses paid or incurred after 1976 and before June 1, 1981, incurred in connection with traveling between a taxpayer's residence and place of work, be made in accordance with the rules in effect prior to 1976. This restriction expired in 1981.

In addition, taxpayers may deduct business expenses, including the cost of transportation, meals and lodging, incurred in connection with the temporary employment away from the taxpayer's regular or principal place of employment. Whether employment is temporary depends upon an analysis of all of the facts and circumstances surrounding the employment arrangement. In this regard, the Internal Revenue Service recently issued a ruling Rev. Rul. 83-82, 1983-22 I.R.B. 5, which provided guidelines to determine whether an employment arrangement is temporary.

H.R. 4253

H.R. 423 would establish a special rule for persons emloyed at the anti-ballistic missile project near Nekoma, North Dakota after 1969 and before 1975 which would allow such individuals to treat all transportation and travel expenses incurred with respect to such employment as transportation expenses incurred in connection with "temporary" employment. The individuals described in H.R. 4253 could, within one year of the date of enactment of the provision, seek a refund or credit of overpayment of federal income tax resulting from the bill's characterization of such transportation expenses, despite any such refund or credit being barred by any law or rule of law.

DISCUSSION

The apparent intention of the bill is to permit a covered individual to deduct all transportation and travel costs incurred in connection with his employment at the missile project during the years in question. We oppose the adoption of such a special rule for a narrow class of taxpayers without regard to the circumstances surrounding any individual taxpayer's employment arrangement.

Whether a taxpayer's employment is temporary, as opposed to permanent or indefinite, for purposes of determining the deductibility of travel and transportation expenses, involves difficult factual and tax policy issues. The recent ruling issued by the Service on this question was a significant step toward resolving some of the uncertainties in this area. In addition, there is an active regulations project which addresses the subject of travel expenses incurred in connection with temporary jobs. We hope that the project will be completed and that new regulations will be promulgated in proposed form in the near future. Because this area is now under intensive study and because we intend to propose rules of general application in this area, we must oppose the bill.

H.R. 4206

INCOME TAX EXEMPTION FOR AMERICAN SERVICE PERSONNEL WHO DIE AS A RESULT OF HOSTILE ACTIONS OUTSIDE THE UNITED STATES

BACKGROUND

Section 692 of the Code currently provides an income tax exemption to any individual who dies while in active service as a member of the United States Armed Forces, provided that the death (or the mortal injury or disease) occurred while the individual was serving in a "combat zone." The term combat zone covers only those areas which the President of the United States by Executive Order has designated as an area in which American servicemen are or have engaged in combat. No area has been so designated since April 24, 1965, when an Executive Order designated Vietnam and certain adjacent waters as a combat zone.

H.R. 4206

H.R. 4206 would extend the income tax exemption of section 692 to apply to any active member of the United States Armed Forces who dies as a result of a hostile action outside the United States, whether or not the death occurs in an area officially designated as a combat zone. This exemption would apply to any income tax imposed with respect to taxable years beginning with the first taxable year in which the member of the Armed Forces first served outside the United States, and ending with the year of death. The bill also waives liability for income tax (and for any interest, penalties or additions to tax) for taxable years preceding such years of foreign service which are still open as of the date of death. The bill would apply to all taxable years of individuals dying after December 31, 1979.

DISCUSSION

The Administration strongly supports this proposal. We also commend this Subcommittee for its quick action in scheduling a hearing on this legislation in order to help assure its prompt passage.

We suggest, however, that several modifications be made to the bill as currently drafted. First, we recommend that the exemption apply to members of the Armed Forces who die as a result of wounds, disease, or injury received in the line of duty outside the United States as a result of either incidents of violence or aggression directed against the United States or one of its allies.

Second, we would advise against extending the exemption retroactively to all years beginning with the year in which the deceased individual first was sent abroad. Such a rule would require the family of any deceased individual to go through the procedure of filing a claim for refund with the Internal Revenue Service in order to recover taxes paid for prior years. This requirement would run counter to one of the principal purposes of this exemption, which is to eliminate the need for any of these families to concern themselves with the tax liabilities of a deceased family member. Moreover, because the size of the refund claims would vary widely (depending upon how long the deceased person had served abroad as well as upon each individual's income), H.R. 4206 would result in the granting of significantly different sums of money to the families of those Armed Services personnel who are killed in the line of duty. We do not believe that this Subcommittee intends any such result.

Chairman STARK. Thank you.

I would ask if any of the members would like, according to the Marquis of Queensbury's rules, to have at the Treasury in support or defense of their position?

Mrs. Kennelly.

Mrs. KENNELLY. Mike, to summarize your testimony on H.R. 3529, you do not oppose anything in the bill and believe potential loopholes have been closed. However, I think you said you would like to see section 1(c) expanded beyond the scope of this bill to place a limitation on all corporations that would like to be RIC's rather than just personal holding companies seeking RIC status, is that correct?

Mr. **Rollyson**. Yes. I think that is a proper summary.

Mrs. **Kennelly**. I just want to make sure I understand your position. Is this a problem you see occurring because of my bill, or is it something you would like to see taken care of anyway, and this seems like an appropriate place to do it?

Mr. **Rollyson**. I think the latter. This is a problem of general concern. It is not a problem that arises because of this bill.

Mrs. **Kennelly**. So if we deal with it in this bill or at a later date, that will not affect the support you have given my bill?

Mr. **Rollyson**. It would be nice if we could deal with it at the same time. I do not think the suggestion is a major suggestion. I think we can work out an appropriate change, and we would like to do that if possible. But I will not say it would be fatal if we did not.

Mrs. **Kennelly**. It would not be.

Just a few other questions. On education assistance programs, have you detected any waste, fraud or abuse in these programs?

Mr. **Rollyson**. I am not aware of any studies that the Internal Revenue Service has undertaken into these particular programs. I think our objection is more a principled objection that there are specific laws regarding the deductibility of educational expenses. Those rules require that these expenses be essentially job related, and I think that test under those regulations is much more appropriate than the qualified educational assistance test which really has very limited requirements to it.

Mrs. **Kennelly**. One last question. A large number of employees are participating in this program which has proved successful. If they are taking a fall course which ends in December, and they do not get their marks until January, and this really determines whether they are reimbursed, will this lead to taxable income because the money arrives after the expiration of the law?

Mr. **Rollyson**. I think that would be a transition rule question, if I heard your question properly. Could you repeat it?

Mrs. **Kennelly**. Yes, sure. If the students are taking fall courses which end in mid-December but do not get reimbursed for them until January when grades usually arrive, will this lead to taxable income because the money arrives after the expiration date of current law?

Mr. **Rollyson**. I think technically it probably would be included in income, since typically one is taxed on when one receives income, and if the exclusion provision were not then applicable, I think it would be taxed at that time. I can see, however, that it might be appropriate to provide some relief for payments under that type of program.

Mrs. **Kennelly**. Mr. Chairman, regardless of what happens, could we look at this particular situation?

Chairman **Stark**. Would the gentlelady repeat herself?

Mrs. **Kennelly**. In the situation where the money arrives in January for the previous semester's work, which could become taxable income, if we could just look at this, regardless of what happens with the bill.

Chairman **Stark**. I am sure that is something we could consider in debating the legislation. I am glad you called it to our attention.

Mrs. **Kennelly**. Thank you, Mr. Chairman.

Chairman **Stark**. Mr. Dorgan.

Mr. **Dorgan**. Thank you, Mr. Chairman.

I do not have any questions.

Chairman **Stark**. Are you sure?

Mr. **Dorgan**. I have a statement I would like to make, however.

Chairman **Stark**. All right.

Mr. **Dorgan**. The issue involved in the bill I have sponsored is not an issue of whether or not the people who would be involved in this very narrow opening—the opportunity to file refund claims—merit the refund claims.

The eighth circuit court of appeals has ruled in favor of the workers on the merits. Because of the construction of the ABM site in North Dakota between 1970 and 1974, the eighth circuit court of appeals ruled that two things intercepted the 12-month temporary versus permanent work rule and the attendant deductibility of travel expenses associated with that rule.

One is that no one knew how long that project would last because at the time we were negotiating SALT with the Soviets, and there was a question of whether that project would even be completed. Thus, no one knew how long their job would last.

No. 2, the expenditure of $1 billion in Nekoma, N. Dak., meant there was not housing available for people to move to that area in connection with their work. The result was that the eighth circuit said clearly these people should be allowed to deduct their travel expenses to and from the jobsite in that particular situation.

The eighth circuit's ruling notwithstanding, the Service did not hold open the statute for these people, these 150 or so people who are affected and could file for a refund claim under this bill. So the situation is the IRS, which had previously audited and collected back taxes by disallowing the travel expenses, have a favorable court ruling which should be applied to people similarly situated but have been prevented from getting their refunds because the Service did not hold open the statute.

I was the State revenue commissioner at the time. I took administrative action which I thought was the right thing for those workers. The IRS took action which I think in retrospect they probably regret, but nonetheless, action which prevents some workers from getting refunds the court says are due them. And this is the way to accomplish it, and that is why I am going to do it.

Thank you.

Chairman **Stark**. Mr. Schulze.

Mr. **Schulze**. Thank you, Mr. Chairman.

I was not going to take much of the subcommittee's time, but I would like go over a few points, Mr. Secretary.

First of all, targeting. We certainly are not targeting in this bill. What we are doing is correcting an anomaly which happened inadvertently. Had Congress known what was going to transpire, it certainly would have taken care of this situation, and I think anyone who looks over the case would agree.

I am not aware of any other situations similar in the country, although there may be. Thus, we do not feel that we are targeting.

Corrective legislation is often retroactive; in fact, probably more often retroactive than prospective. Therefore, I see no problem with that.

I appreciate Treasury's interest, but feel that the committee knows we are going to do what is right, and we will not take any more of your time.

Thank you.

Mr. **Rollyson**. I might just add, Congressman Schulze, that I think we would have less objection if the bill were made applicable to all payments similarly situated. We have been trying to ascertain how many such payments there are, and we have not been able yet to determine that. But I think we would have less objection if the bill were widened because it really was a transition problem.

Mr. **Schulze**. I agree. Let me state, if between now and markup you can come up with language, I really do not know whether it is necessary, because I think if there were other cases, we would have heard of them by now. But if you feel more secure with language which would broaden it a little bit, and share it with me, my staff, or the committee staff, we will certainly consider it.

Mr. **Rollyson**. We do want to study what the revenue impact would be.

Chairman **Stark**. Thank you very much, Mr. Rollyson. We appreciate your testimony.

If there are no other questions, we will next call our colleague, Mr. Shannon, a distinguished member of the full committee, for what I understand will be brief testimony. He has voluminous other legislative commitments around Capitol Hill this afternoon—none more important, I might add, than H.R. 2568.

Jim, would you proceed in any manner you see fit?

STATEMENT OF HON. JAMES M. SHANNON, A REPRESENTATIVE IN CONGRESS FROM THE STATE OF MASSACHUSETTS

Mr. **Shannon**. Thank you, Mr. Chairman, members of the subcommittee.

Let me just say at the outset I agree completely with Mr. Dorgan's position on the North Dakota legislation. I look forward to working with you on that, Mr. Dorgan.

Mr. Chairman and members of the subcommittee, thank you for allowing me to appear before you today. As you know, I introduced two of the bills you are considering, H.R. 667, related to the tax treatment of faculty housing, and H.R. 2568, the extension of the employee educational assistance provisions.

I would like to tell you why I think it is essential that these bills be enacted before Congress goes home this year. Let me begin with the faculty housing problem.

For many years it has been a common practice among numerous colleges and universities to offer rental housing on or near campus to faculty members and administrators. In many cases, the rent charged for this housing, although sufficient to cover the institution's costs, has been below the rent that could be obtained on the commercial market. This housing has been made available not just for the convenience of the employee, but because it was felt it would enhance the educational atmosphere of the school to have faculty and administrators close at hand where it would be convenient for students to meet with them on an informal basis.

In April 1982 the IRS issued technical advice memorandums in cases involving four New England colleges which held that when colleges and universities provide rental housing to their employees at less than the commercial fair rental value, the difference between that value and the rent actually charged constitutes income to the employee under the rules established by section 119 of the Internal Revenue Code.

What was particularly disturbing was the IRS's decision that this income was wages subject to income and social security tax withholding and that the colleges would be retroactively liable for the amounts they had failed to withhold.

This harsh position is both unnecessary and unfair. The colleges involved were charging what they believed to be reasonable rents. These rents covered the cost to the school of owning the property and reflected the value to them of having faculty and administrators living in these houses. These values are considerable. Besides the educational benefits already mentioned, the availability of attractive and affordable housing near their place of employment can be an important factor in attracting top quality faculty to an institution. A strict commercial valuation does not adequately recognize these considerations.

There is ample precedent in both case and administrative law for the use of methods other than commercial market valuation to determine the value of property or services, including both the cost to the employer and the value to the recipient.

What is more, the IRS position seems to fly in the face of the Supreme Court's decision in *Central Illinois Power Co.* v. *The United States,*[1] in which the Court held that an employer had no duty to withhold tax on lunch reimbursements to its employees where its liability was not certain; as well as the IRS's own Revenue Ruling 80-53 published in response to *Central Illinois* which states that withholding will not be required where the employer has a reasonable basis for believing the benefits involved constitute wages, and no statute or other authority specifically requires withholding.

This sudden move against a practice that had gone unchallenged for years also seems to be a violation of the still-existing moratorium on regulatory changes in fringe benefit taxation.

The retroactive nature of the IRS decision is, as I have said, particularly disturbing. These schools were operating in the good faith and utterly reasonable belief that this housing was not a taxable benefit. If the IRS's policy is implemented, the resulting tax assessments would be a severe financial blow to institutions already suffering from spiraling costs and reduced Federal aid, and whether retroactive or prospective, the policy would, in many cases, force schools to sell off their housing units, thus ending what has become an integral part of the educational atmosphere at many colleges and universities.

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[1] 435 U.S. 21 (1978).

It is doubtful that all of this would bring much revenue to the Treasury. We might even experience a revenue loss as the property was acquired by private owners who began taking the homeowners' deductions.

H.R. 667, which prevents the IRS from implementing this policy before July 1, 1984, was designed to address the retroactivity problem while leaving the overall policy issue to be dealt with in the context of whatever legislation was enacted in conjunction with the expiration of the fringe benefit moratorium.

As it turns out, however, that legislation, for reasons which I can certainly understand, does not address this issue. It is therefore my hope that when H.R. 667 is marked up, either the subcommittee or the full committee, hopefully the subcommittee, will accept an amendment that will settle the issue for the future as well.

Such an amendment would state that the value of this type of housing would not be included in an employee's income so long as a reasonable rent was charged that was greater than the employer's direct cost. Whether a rent was reasonable would be determined by such factors as the extent to which the cost of furnishing the housing were covered, the value of the housing to the employee, and the educational purpose in furnishing it. The fact that the rent was less than the fair rental value could not of itself be a determining factor.

I cannot emphasize strongly enough the importance of acting as soon as possible to remedy this terribly unfair situation. The IRS has already begun to move against the original four schools. Dozens of others are waiting for the tax man to descend upon them.

I urge the subcommittee to take prompt action on H.R. 677 and save these schools from taking a financial beating they do not deserve.

The second bill, H.R. 2568, deals with another issue of importance to education—employee educational assistance. It would, very simply, take the 1983 sunset date out of section 127 of the Internal Revenue Code which allows such assistance to be excluded from an employee's income and make this provision permanent.

When we put a sunset date into a new code provision it is usually because we want to see whether and how it will work. If the provision is not working well, the sunset date forces us to either end the provision or fix it up.

Well, I do not think there can be any doubt that section 127 has worked and worked well. I have received letters from companies in every area of business, and they have all told me they have made extensive use of employee educational assistance programs. These have enabled them to upgrade their employees' skills and keep them current with new developments in their field—an especially important consideration for high technology industries. They have also allowed employees working at low level jobs, particularly minorities and women, to obtain the skills and training they need to move into better positions.

Labor unions, who also support the bill, consider educational assistance an important part of the benefit plans for which they bargained. And educational institutions say these programs have allowed them to serve students who would otherwise be unable to afford an education.

There is also widespread agreement that these benefits could not continue if section 127 expired, and we returned to the rule that prevailed before it was enacted in 1978. Under the old rule, educational assistance was only excludable if it was directly related to an employee's current responsibilities. Educational assistance designed to allow employees to improve their position was therefore available only to those employees willing to pay a tax on it, and many of them were not.

Furthermore, the job-relatedness test was often difficult to interpret. Rulings by various IRS offices were often inconsistent. This created even more of a disincentive to the use of such programs.

We have talked a lot both in the Ways and Means Committee and in the House about the importance to our country's future of having a well-trained, well-educated work force. We also talk a lot about the need to insure all Americans, particularly those who have been disadvantaged by race, gender, or economic status, to have an opportunity to obtain an education and improve their position in life.

Employee educational assistance programs have been shown to do both these things effectively and at a low cost—only $40 million a year in lost revenue. Section 127 is one provision that should stay in the code, and I hope we will be able to make sure it does before the December 31 expiration date.

Thank you, Mr. Chairman.

Chairman **STARK**. Thank you, Mr. Shannon, for summarizing your remarks.

I wanted to ask you if your idea of above-market rents would be the kind of situation where, say, on the campus of Wellesley College there was a house for rent that might rent in Wellesley Hills for $600, but my classmates and I from MIT might have been willing to pay $6,000 a month to have lived there some years ago.

Would that be considered an artificial market?

Mr. **SHANNON**. I think even $6,000 a month would be too little to house your classmates and you at MIT. [Laughter.]

Chairman **STARK**. Mr. Duncan.

Mr. **DUNCAN**. I would say the chairman can afford the $6,000, too.

I want to thank you, Jim. I certainly support your legislation.

Mr. **SHANNON**. Thank you, Mr. Duncan.

Chairman **STARK**. Mr. Dorgan.

Mr. **DORGAN**. Is this Mr. Conte's legislation as well?

Chairman **STARK**. We are going to hear from him in a minute, but Mr. Shannon will escape.

Mr. **SHANNON**. Mr. Dorgan, I am just here to warn you about Mr. Conte.

Mr. **DORGAN**. I wanted to be supportive of Mr. Conte. We worked together on so many issues.

Mr. **MOORE**. The Dingleberry bill, was that one of them? [Laughter.]

Chairman **STARK**. Mr. Schulze.

Mr. **SCHULZE**. I would just like to thank our colleague for an outstanding presentation.

Chairman STARK. Mrs. Kennelly.

Mrs. KENNELLY. I would like to compliment Mr. Shannon on the excellent testimony with which I wholeheartedly agree.

Can you tell us or give us any idea how big a problem this is to schools?

Mr. SHANNON. You are talking about the faculty housing problem? I think it is a very big problem for schools because they have been put in fear. So many educational institutions provide faculty housing and have for such a long period of time that even those schools that have not yet been visited by the IRS or notified by the IRS are terrified as to what might happen down the road, and they have had to think about how they would meet this problem if it were to develop, which it eventually will unless we take some legislative action.

I do not have to tell you, Mrs. Kennelly, the terrible problem many of our higher educational institutions already have in trying to meet their budgets, and this will be a real burden, I think, at a particularly difficult time to them if they have to deal with this problem.

Mrs. KENNELLY. And we are talking about as much money as $1 million in a particular case?

Mr. SHANNON. Yes, clearly for some institutions.

Chairman STARK. Mr. Moore.

Mr. MOORE. No questions. Thank you.

Chairman STARK. Thank you very much.

Mr. SHANNON. Thank you very much, Mr. Chairman.

Chairman STARK. I would now like to introduce our distinguished colleague from Massachusetts, Congressman Conte. He would like to introduce some distinguished colleagues from his section of the State who will constitute our next panel.

STATEMENT OF HON. SILVIO O. CONTE, A REPRESENTATIVE IN CONGRESS FROM THE STATE OF MASSACHUSETTS

Mr. CONTE. Chairman Stark and members of the subcommittee, I am certainly delighted to have this opportunity to appear before you today in your consideration of H.R. 677, legislation which was introduced by Barber Conable, Jim Shannon, and others to provide tax treatment for faculty housing programs. I am also a cosponsor of this legislation. And as you know, I was the author of the amendment to the supplemental appropriations bill earlier this year which prevented the IRS from implementing any rule governing faculty housing.

I do want to take this opportunity now to introduce a very dear friend of mine from Massachusetts, Jill Conway, the president of Smith College. She will be speaking in strong support of H.R. 677, as president of one of the colleges which provides housing to its faculty members and which is also being investigated by the Internal Revenue Service.

Jill Conway was born in New South Wales, Australia. She received her bachelor's degree from the University of Sydney in Australia in May 1958. In 1969 she received her Ph. D. from Harvard University in Cambridge where she focused on women's studies generally.

Her career from the time she received her bachelor's degree has been tremendously impressive. She was a lecturer at the University of Sydney, a teaching fellow at Harvard, a lecturer at the University of Toronto and assistant professor there, and finally, associate professor from 1970 through 1975.

In 1975 Jill was appointed to her current position as president of Smith College where she is also a history professor. I have pages and pages here on Jill, but I will not take your time. I know you will want to hear from Jill Conway and her panel, and I will, therefore, spare you all and submit my statement on this bill for the record.

Thank you again, Mr. Chairman and members of the committee.

[The prepared statement follows:]

STATEMENT OF HON. SILVIO O. CONTE, A REPRESENTATIVE IN CONGRESS FROM THE STATE OF MASSACHUSETTS

Mr. Chairman and Members of the Subcommittee, I want to thank the Members of the Select Revenue Measures Subcommittee for agreeing to hold hearings on H.R. 677, legislation introduced by Messrs. Shannon, Conable, Duncan, Anthony, Frenzel, myself and others to clarify the issue of tax treatment of housing provided by a college or university to its faculty members. In my statement today, I hope to focus on three major points: the controversy involved, the incorrect interpretation of the law by the Internal Revenue Service, and possible legislative remedies.

Mr. Chairman, the background surrounding this issue is not in any real controversy. Many coleges across the nation provide reduced-cost to their faculty members, in housing units owned by the institution. The low-cost rent is generally not in the form of a cash subsidy, but rather merely low-cost housing provided reflecting only the institution's direct cost in providing the housing. In simpler terms, the fair market value of a housing unit may be $400 per month, but the college will charge $300 per month, which is equal to the college's cost in providing the housing unit. The Internal Revenue Service (hereafter, the Service) contends that the difference between the fair market value of the housing and the rent actually paid constitutes income to the employee, and should be subject to employment taxes. In audits of several colleges, the Service apparently seeks to impose taxes retroactively.

Present law (Internal Revenue Code Section 61) defines "gross income" as being "all compensation, from whatever source derived." The Code also specifically deals with meals and lodging provided by an employer for an employee. Code Section 119 provides that the value of qualified campus lodging can be excluded from gross income if the lodging meets the following three rules:

(a) The lodging is on the business premises of the employer; (b) the lodging is provided for the convenience of the employer, and; (c) the employee is required to accept the lodging as a condition of employment.

According to the Service position, the schools being audited do not meet the Code Section 119 requirements, and taxes must be paid on the value of campus housing retroactively. Due to the administrative impracticability of seeking back taxes from the affected employees, the Service apparently feels that they can automatically seek back taxes from the individual universities and colleges involved.

In general, then, this is the background presented in this case. An amendment to the Fiscal Year 1983 Supplemental Appropriations bill prohibited the use of funds for the Service to enforce any ruling or take any action, to impose taxes on the value of campus lodging provided by any college or university. In my opinion, H.R. 677 addresses the concerns of the affected educational institutions, while at the same time correcting what I consider to be a mistaken interpretation of the law by the Service.

The central issue in this case comes down to this question: if an employee receives "gross income," is their employer then required to withhold? If housing provided by an employer does not meet the Code Section 119 requirements, then its value cannot be excluded from income. In other words, the value to the employee of the housing is indeed "compensation" as defined in Code Section 119. But a requirement to withhold employment taxes does not necessarily follow from a determination that reduced-rent faculty housing constitutes "income" within the meaning of Code Section 61. In fact, the Supreme Court, in its 1978 ruling in *Central Illinois Public Service Company* v. *the U.S.* (435 U.S. 21) held that an employer's obligation to withhold be precise and not speculative. In its decision, the Court specifically rejected the argument that an item which is income to the employee because it is not excludible under Code Section 119 is also automatically "wages" for withholding purposes.

In its response to the *Central Illinois* decision, the Service published Revenue Procedure 80-53, 1980-2 C.B. 848. The Revenue Procedure generally provides that withholding will not be required where (a) the employer has a "reasonable basis" for its belief that the benefits should not be considered remuneration for services, and (b) no statute or other legal authority specifically required withholding. The Internal Revenue Code provides quite a different standard and definition for "income" as it does for wages. Wages are considered to be "remuneration for services." It does not automatically follow that "income" not excludible under Code Section 119 is subject to withholding.

This fact is a logical conclusion which can be drawn from the *Central Illinois* decision, prior case law, and expressions of legislative intent for years. Unfortunately, the Service specifically rejects this argument in Revenue Ruling 81-222, 1981-39 I.R.B. 8. This ruling says that meals and/or lodging which are not excluded from taxable income by Code Section 119 automatically constitute "wages" subject to withholding. The ruling, however, disregards the fundamental question of whether certain items are provided as "remuneration for services." The IRS cites no authority for this unique proposition.

In its 1978 holding, the Supreme Court looked closely at the difference which exists between income and a requirement to withhold. The Court looked, for example, at the Individual Income Tax Act of 1944, "the structure of which survives to the present day," which stresses the need for simplicity and ease of administration in determining whether or not to withhold taxes from income. The Court cited a large number of prior lower court decisions which held that if an employer bestowed a benefit constituting taxable income to an employee, the decision to withhold would depend on if the benefit was paid for a compensatory purpose, or "to advance [the employer's] own wholly legitimate and bona fide business purposes," (*People's Life Insurance Company* v. *U.S.* F.2d. 927,373 67-1 USTC-9301). In my view, providing low-cost faculty housing meets the latter criteria.

I turn briefly now to another problem that I have with the IRS position, and that is with the historical tax treatment of fringe benefits generally. For many years, at the request of the three prior administrations, Congress has attempted to provide for permanent rules for the tax treatment of fringe benefits. When the Congress failed to act, the Treasury Department published their own proposals. Yet Congress did not like the Treasury proposals, and in 1978, imposed a moratorium on the issuance of all regulations dealing with fringe benefits. That moratorium, which expired in 1981, was extended as part of the Economic Recovery Tax Act (ERTA), and will now expire on January 1, 1984.

The general moratorium prohibited the Internal Revenue Service from issuing final regulations, under Code Section 61, relating to the income tax treatment of fringe benefits. The Service contends that their decisions on the faculty housing issue are not based on Code Section 61, but rather Section 119. There is only one problem with this line of reasoning. The General Explanation of the Economic Recovery Tax Act of 1981 explains that "it is the intent of Congress that the Internal Revenue Service will not in any significant way alter, or deviate from, the historical treatment of traditional fringe benefits through the issuance of revenue rulings or revenue procedures." This statement of Congressional intent could not be more clear. By their technical advise memoranda, the Service has deviated from their historical treatment on the subject of campus housing—which is a "traditional fringe benefit."

Mr. Chairman, it is my view that the IRS has misinterpreted an established series of case law, as well as the intent of Congress in passing the fringe benefits moratorium, by attempting to apply employment taxes retroactively on certain colleges. Thus, H.R. 677 is necessary to express clear Congressional intent that taxes are not required on the value of qualified campus lodging for tax years prior to 1984. I believe that the legislation should be amended, however, to either provide a permanent Section 119 exclusion, or, to clarify that in the future, gross income does include the value of reduced-cost campus lodging. Personally, I would prefer a permanent exclusion, which would necessitate a revision of Code Section 119. However, such an exclusion would assist many colleges, who cannot afford to pay large salaries, in attracting the most qualified personnel for their faculty. In the same manner as "tuition remission" programs of many schools are exempted from the Permanent Tax Treatment of Fringe Benefits Act of 1983, perhaps a permanent exclusion could be provided for this fringe benefit as well. This would, of course, necessitate further study by the Ways and Means Committee.

In either event, Mr. Chairman, this issue should be clarified once and for all. I am strongly supportive of the concepts embodied in H.R. 677. I urge the Subcommittee to adopt this legislation, urge favorable action on it by the full Ways and Means Committee, and urge its adoption in some revenue measure before the Congress adjourns this year.

Once again, Mr. Chairman, I thank you for your efforts on this matter, and appreciate the consideration you have shown us on this legislation.

Mr. DORGAN [presiding]. Congressman Conte, your statement will be entered into the record. We appreciate your willingness to come forward and testify, and we appreciate your introducing the panel.

We will call on Jill Conway and ask Ms. Conway if you will proceed and introduce the members of the panel.

Thank you, Congressman.

Mr. CONTE. I will excuse myself, Mr. Chairman.

Mr. DORGAN. Thank you very much.

STATEMENT OF JILL K. CONWAY, PRESIDENT, SMITH COLLEGE, ACCOMPANIED BY JAMES R. HOPKINS, TAX COUNSEL, SMITH COLLEGE

Ms. CONWAY. Mr. Chairman, my name is Jill Conway. I am very grateful to be present here this afternoon. I am particularly grateful for Congressman Conte's introduction.

As president of Smith College in Northampton, Mass., I am pleased to be here to have an opportunity to speak to you as you consider House bill 677.

I am accompanied by a very comprehensive group of experts who can speak on this subject. On my left is Mr. James R. Hopkins, counsel to Smith College, who is available to answer questions of detail about the specific impact of the current IRS policy. On my immediate right, Mr. Alfred D. Sumberg, associate general secretary of the American Association of University Professors; and further to my right, Dr. Merle Allhouse, president of Bloomfield College, N.J., who can also testify very directly as to the impact of the current IRS policy on our institutions.

I would like to address the tax treatment of traditional faculty housing programs maintained by various educational institutions. I am speaking today specifically on behalf of my own college, Smith, and also Amherst College, Wellesley College, Wesleyan University, and the 13 educational associations that I listed on my formal written statement.

These educational institutions and associations are unanimous in their support for H.R. 677. They represent a wide range of both public and independent institutions of higher education along with independent secondary schools.

Smith's faculty housing program involves the rental of houses and apartments to approximately 120 faculty members and certain administrators, deans and other officials who deal with students, and their families.

The college maintains the program in order to have a substantial number of faculty members and administrators living on or near the campus as a part of an extended campus community that is conducive to informal interactions between faculty members and students.

I have very carefully described Smith's housing program as a traditional faculty housing program because it resembles the housing programs that exist and have existed for many years at numerous colleges, universities and secondary schools across the country for as many as 100 years in some places, 60 years in my own case.

Under Smith's program, housing is rented to faculty members at a substantial rent that reflects the college's cost of providing the housing, the educational purposes the college serves by having faculty members living on or near the campus and the value of the housing to our faculty members.

There is no substitute cash living allowance provided to employees who elect not to live in faculty housing. For decades Smith has maintained this housing program, believing the rents charged were reasonable to both the college and the faculty in question.

An IRS agent asserted, however, that because Smith possibly could have rented its housing units on the open commercial market at higher rents, the difference between the higher theoretical fair rental value and the rent charged a faculty member constituted an additional income to the faculty member in question.

Further, the agent maintained this income to the faculty member constituted wages paid by Smith that are retroactively subject to income tax withholding and social security taxes back to 1974.

The position of the agent was incorporated in formal action by the IRS at the end of 1981 in two technical advice memorandums. It is our belief that the IRS position is incorrect for several reasons.

First of all, the value of the housing cannot be measured simply by reference to what a business executive or someone else might be willing to pay on the commercial market. If Smith had to charge this rent, our professors would be squeezed out. It is more appropriate to measure the value of faculty housing with reference to an educational institution's cost, the educational purposes served by the housing program, and the value of the housing to faculty members.

Second, the IRS position violates the Supreme Court's 1978 holding in *Central Illinois Public Service Company* v. *The United States:* that an employer's obligation to withhold taxes must be precise and not speculative, and that an employer should not be treated as the guarantor of its employees' taxes.

In light of the numerous issues regarding the value of the housing and whether the rental of the housing constitutes wages subject to withholding, Smith clearly did not have a precisely defined withholding obligation.

Third, the IRS position is contrary to the fringe benefit moratorium which Congress passed in 1978 to prevent the IRS from altering its historical administration of the tax laws with regard to fringe benefits. No Internal Revenue Service Code section, regulation, ruling or decided case has ever provided that a traditional faculty housing program gives rise to wages subject to withholding.

For the IRS to assert a retroactive employment tax liability now after a traditional housing program has been maintained for decades appears to violate the congressional intent in passing the moratorium. The IRS position is also a departure from its own former administrative position involving company cafeteria meals valued at the employer's cost.

We would like to propose that Congress remedy the inequity created by the new IRS position, and we have three remedies to propose.

First, as to the present and to the past, Congress should clarify the application of the fringe benefit moratorium to traditional faculty housing programs so as to prevent the imposition of retroactive withholding taxes.

House bill 677 would have this effect by providing for tax only in certain instances with respect to any excess cost not fully recovered by rents.

Second, if the fringe benefit moratorium is extended beyond December 31, 1983, in order to provide time for Congress to reach a comprehensive resolution of the fringe benefit question as we understand may be contemplated in the Senate and in the Congress. Congress could make it clear that the moratorium applies to traditional faculty housing programs both as to the past and for any extension period.

Third, for the future Congress should make it clear through legislation that traditional faculty housing programs do not give rise to taxable income so long as the colleges' direct costs are recovered.

We propose that H.R. 677 or other pending legislation be amended to provide for such an exclusion.

I would like to emphasize that traditional faculty housing programs do not provide a significant source of revenue for the Government. The alternative for educational institutions such as my own were the current policy to continue would be for us to sell off the housing. The resulting cost to the Government from homeowner deductions would, in all likelihood, exceed the amount being sought by the IRS in these cases.

I would like to urge the subcommittee and the full committee on behalf of many institutions and individuals represented by the educational institutions and associations listed in my full testimony not to allow this inequitable situation created by the IRS to continue. Smith, in its efforts to provide excellence in all aspects of education, has maintained its faculty housing program for more than one-half a century. The continuing need for excellence in American education, an excellence that must exist both within and without the classroom, calls for your support for such programs and for a remedy for this particular situation.

Thank you, Mr. Chairman.

[The prepared statement follows:]

STATEMENT OF JILL K. CONWAY, PRESIDENT OF SMITH COLLEGE

This statement addresses the tax treatment of traditional faculty housing programs. It is being submitted by Jill K. Conway, President of Smith College in Northampton, Massachusetts, to the Select Revenue Measure Subcommittee of the House Ways and Means Committee in connection with its consideration of H.R. 677.

This statement is submitted on behalf of Smith College, Amherst College, Wellesley College, Wesleyan University and the following 13 educational associations:

American Association of State Colleges and Universities;
American Council on Education;
Association of American Universities;
Association of Catholic Colleges and Universities;
Council of Independent Colleges;

Federation of Independent Illinois Colleges and Universities;
Independent Colleges and Universities of Missouri;
National Association of College and University Business Officers;
National Association of Equal Opportunity in Higher Education;
National Association of Independent Colleges and Universities;
National Association of Independent Schools;
National Association of Schools and Colleges of the United Methodist Church; and
National Association of State Universities and Land-Grant Colleges.

The foregoing educational institutions and associations are unanimous in supporting the passage of H.R. 677. Although this statement specifically discusses Smith's faculty housing program, it is generally applicable to all educational institutions that maintain traditional faculty housing programs.

A. DESCRIPTION OF A TRADITIONAL FACULTY HOUSING PROGRAM

Smith operates a faculty housing program that rents houses and apartments to approximately 120 faculty members and certain administrators (for example, deans) and their families. The College maintains the program in order to have a substantial number of faculty members and administrators living on or near campus as part of an extended campus community, one that is conducive to informal interactions between faculty members and students. This sense of community has long been an integral part of the educational experience at Smith as a small, residential, liberal arts college. Yet whether an educational institution is located in a rural, suburban or urban setting, a traditional faculty housing program, by creating a sense of collegiality among the faculty members and by encouraging student-faculty interaction outside the classroom, serves important educational goals of the institution.

Smith's housing program is accurately described as a "traditional" faculty housing program because it resembles the housing programs that exist and have existed for many years at numerous colleges, universities, and secondary schools across the country. Under Smith's program, housing is rented to faculty members at a substntial rent that reflects the College's cost of providing the housing, the educational purposes of the College served by having faculty members living on or near campus, and the value of the housing to the College's faculty members. No substitute cash living allowance is provided to employees who elect not to live in faculty housing.

B. THE INTERNAL REVENUE SERVICE'S POSITION

Smith had maintained its housing program for decades, believing that the rents charged were reasonable to both the College and its faculty members.

The Internal Revenue Service, however, saw things differently. An IRS agent asserted that because Smith possibly could have rented its housing units on the open commercial market at higher rents, the difference between the higher theoretical "fair rental value" and the rent charged a faculty member constituted additional income to the faculty member. Furthermore, the agent maintained that this "income" to the faculty members constituted "wages" paid by Smith that were subject to retroactively-applied income tax withholding and social security taxes. The agent argued that Smith should have withheld these taxes during years extending back to 1974. The position of the agent was incorporated in formal action by the IRS at the end of 1981 when the IRS National Office issued two technical advice memoranda that treated traditional faculty housing programs at Amherst and Wesleyan as giving rise to retroactive withholding tax liability for years going back to 1973 (Technical Advice Memoranda #8213005 and #8219001).

C. WHY THE IRS POSITION IS INEQUITABLE AND UNPRECENDENTED

It is our belief that the IRS position is both inequitable and unprecedented for several reasons, three of which will be touched upon in this statement. First, the value of faculty housing cannot be measured simply by reference to the commercial rental market. Second, the IRS position is contrary to the Supreme Court's holding in *Central Illinois Public Service Company* v. *United States*, 435 U.S. 21 (1978). Third, the IRS action appears to violate congressional intent in passing Public Law 95-427, the "fringe benefit moratorium". Each of these reasons will be discussed in turn, followed by a discussion of the proposed legislative solution to this problem.

1. Valuation of faculty housing

The IRS maintains that the value of Smith's faculty housing must be measured purely by reference to the commercial rental market. Smith maintains, however, that the value of faculty housing must be measured with reference to: (i) the educational goals of the College served by the housing program, (ii) the value of the housing to the College's faculty members, and (iii) the College's cost of maintaining the housing.

It is not relevant to ask what a business executive would be willing to pay to live in Smith College housing because Smith is not a commercial landlord. Smith maintains its faculty housing program to further its educational goal of creating an extended campus community and not as a means of raising money. As is discussed below, if Smith were to change its policy and rent its housing to the highest bidder the result would be the destruction of its faculty housing program, at great educational cost to the College.

Instead of referring to the commercial market, the value of faculty housing should be measured with reference to what is in fact the relevant market—the College's employees. The College has attempted to set its rent at a level that is high enough to recover most or all of its costs in providing the housing and yet low enough to enable faculty members to live in the housing. If the College raised its rents substantially beyond the normal adjustment for inflation, most or all of our faculty members would move to other towns where they would be able to rent housing at a lower price.

There are a number of cases in which courts have held that the value of property or services received by an individual, and included in his income, should be measured with reference to the value to the recipient and not to some theoretical fair market value. For example, in *Reginald Turner,* 13 T.C.M. 462 (1954), the court dealt with taxpayers who had won a free trip to South America and concluded that the trip was not worth its full retail value to them because they might well have not chosen to provide themselves with an item of such value. Faculty members who are given the opportunity to rent housing on or near campus should similarly not be subjected to taxation based on the value of the housing to some abstract third party. Rather, the value of the housing to the faculty member should be given primary attention.

A further reason why it is unreasonable for the IRS to refer only to the commercial rental market is that the IRS has itself taken a contrary administrative position on several occasions. The IRS in those instances has stated that the value of a particular fringe benefit is the employer's cost of providing the benefit rather than a theoretical fair market value. For example, in Technical Advice Memorandum #7740010, dated June 30, 1977, the IRS concluded that "the value of the [cafeteria] meals [furnished to employees] to be included in gross income *is determined by the cost* incurred in furnishing the meal less the amount charged for the meal." (emphasis added).

In light of the unique situation presented by faculty housing programs, case precedent, and the IRS administrative position discussed above, it seems clear that the "value" of faculty housing must be measured not with reference to an abstract commercial market, but to the educational purposes served by the housing program, the value of the housing to the faculty members, and the educational institution's cost of providing the housing.

2. Central Illinois

An employer is not required to withhold taxes from all of the income that is received by an employee, but only from the "wages" that he pays to the employee. The term "wages" is defined in section 3401 of the Internal Revenue Code, with regard to income tax withholding, as "remuneration for services." A similar definition is found at section 3121 with regard to social security, or "FICA" (Federal Insurance Contributions Act), taxes.

In 1978 the Supreme Court held in the *Central Illinois* case, cited above, that a taxpayer/employer was not liable for withholding tax on the payment of lunch reimbursements to employees even though such payments clearly constituted taxable income to the individual recipients (because they were not excludable under Section 119 [1] of the Internal Revenue Code). The Supreme Court concluded that the taxpayer had no duty to withhold because its liability was not "clearly defined" and because an employer should not be a guarantor for the payments of its employee's tax. In its decision, the Supreme Court rejected the argument made by the IRS that an item which is income to the employee because it is outside the exclusion of Section

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[1] Section 119 provides an exclusion from income for meals or lodging furnished to an employee (i) for the convenience of the employer, (ii) on the business premises of the employer, and (iii) (in the case of lodging) where the employee is required to accept the lodging as a condition of employment.

119 is also automatically "wages" (*i.e.*, "remuneration for services") for withholding purposes.

As is discussed further below, no Internal Revenue Code section, regulation, ruling, or decided case has ever stated or held that participation in a traditional faculty housing program constitutes "wages" subject to withholding. In light of this absence of precedent and the fact that traditional faculty housing programs have operated for decades without objection by the IRS, educational institutions can hardly be said to have a "clearly defined" withholding obligation. Moreover, substantial case law (cited by the Supreme Court in *Central Illinois*) has held that an employer is not required to withhold where an item is provided for a dominant business purpose other than compensating employees. In this case, Smith's purpose in maintaining the faculty housing program is educational—to create an extended campus community with regular interchange between faculty and students. *Central Illinois* therefore precludes the assessment of retroactive withholding taxes against educational institutions maintaining traditional faculty housing programs.

In Revenue Procedure 80-53, 1980-2 C.B. 848, the Internal Revenue Service published its response to the *Central Illinois* decision. The Revenue Procedure generally provides that withholding will not be required where (a) the employer had a "reasonable basis" for its belief that the benefits should not be considered remuneration for services and (b) no statute or other legal authority specifically required withholding.

The "reasonable basis" aspect of the Revenue Procedure 80-53 test is clearly satisfied by Smith because of the reasons discussed in section C.1 above, the lack of any decided cases requiring withholding on account of traditional faculty housing programs, the fact that our program and similar programs across the country have existed for decades without objection by the IRS, and the substantial case law supporting non-withholding in view of Smith's business, i.e. educational, purpose in maintaining the housing program.

The IRS, however, has asserted that faculty housing programs such as Smith's fail the other part of the Revenue Procedure 80-53 test—that no statute or other legal authority required withholding. This position of the IRS was announced in the technical advice memoranda concerning Amherst and Wesleyan and is based on an unusual and unsupported extension of an argument first officially stated by the IRS in 1981 in Revenue Ruling 81-222, 1981-2 C.B. 205. Revenue Ruling 81-222 indicates that meals and/or lodging which are not excluded from taxable income by Section 119 of the International Revenue Code automatically constitute "wages" subject to withholding, without regard to the usual and fundamental question in determining "wages"—whether such items were provided as "remuneration for services."

The IRS contended in the technical advice memoranda that the institutions did not satisfy the requirements of Revenue Procedure 80-53 on the theory that a specific regulation—Reg. Section 31.3401(a)-1(b)(9)—treated the housing in question as "wages." That regulation, however, simply states the obviously sound rule that amounts excluded from income under Section 119 will not be treated as "wages" subject to withholding; it in no way suggests that other meal and lodging items (assumed not to be covered by Section 119) are necessarily "wages" without regard to the question of whether they constitute "remuneration for services" in the first place. In the technical advice memorandum that related to the facuility housing program at Amherst, cited above, the IRS said that Revenue Ruling 81-222 "restated" this "principle."

The IRS position, and the application of Revenue Ruling 81-222 to traditional faculty housing programs, is inconsistent with the Supreme Court's *Central Illinois* decision. The *Central Illinois* case itself involved a meal and lodging item—a meal allowance—found not to qualify for the Section 119 exclusion. If the IRS' rationale in Revenue Ruling 81-222 were applied to *Central Illinois* one would conclude that because the lunch reimbursements did not satisfy section 119 they necessarily constituted wages subject to income tax withholding. And yet the Supreme Court's holding was exactly the opposite: despite the fact that the lunch reimbursements were not excluded from "income" by Section 119, they did not fall within the "much narrower" category of "wages." In any event, even if the position stated in Revenue Ruling 81-222 were correct (and we think it is entirely incorrect as applied to traditional faculty housing programs), it would hardly affect an institution's "reasonable basis" for not witholding during years prior to 1981.

It should be noted that Revenue Ruling 81-222 need not be regarded as incorrect if it is properly limited to the factual situation it describes—namely, the provision of free meals or housing. The provision of free meals or housing would arguably involve remuneration for services because it would relieve the employees from a personal expenditure they would otherwise have to incur. This is not the case with respect to traditional faculty housing programs charging subtantial rents reflecting the value of housing to the employees.

3. The fringe benefit moratorium

In 1978, in response to Treasury's attempts to expand broadly the taxation of fringe benefits, Congress enacted the "fringe benefit moratorium" (Public Law 95-427), prohibiting the issuance of new regulations in the frnge benefit area. Moreover, Congress made it clear in legislative history that the moratorium "would prevent the IRS from deviating from the present administration of the tax laws as they concern the taxation of fringe benefits as compensation." Huse Report No. 95-1232. The Report states that the moratorium was imposed because Congress recognized that the lack of uniformity in the fringe benefit area led to inequitable distinctions between taxpayers receiving similar benefits, difficult decisons as to an employer's obligation to withhold taxes, and difficult valuation problems regarding fringe benefits. The fringe benefit moratorium has been extended twie by Congress, most recently by P.L. 97-34, § 801, and remains in effect through Dcember 31, 1983.

The fringe benefit moratorium applies to traditional faculy housing programs because such programs have not previously been challenged by the IRS, because there is no direct legal precedent for imposing additional employment taxes on institutions maintaining such programs, and because the IRS atack on faculty housing programs represents a departure from the cost measure of value which the IRS itself has utilized in other cases.

The IRS has argued on several occasions, such as in the technical advice memoranda concerning Amherst and Wesleyan, that there are cases that establish a precedent for taxing traditional faculty housing programs For example, *Benninghoff* v. *Commissioner,* 614 F. 2d 398 (5th Cir. 1980) aff'g 71 T.C. 216 (1978) (free housing provided to Panama Canal Zone policeman); *McDonald* v. *Commissioner* 66 T.C. 223 (1976) (lodging rented to business executive in Toyko). Those cases do not bear directly on traditional faculty housing programs for several reasons.

These cases, which interpret section 119 of the Internal Revenue Code, do not affect the applicability of the fringe benefit moratorium. It is not sufficient for the IRS to argue that because it has taxed isolated business executives who have received free or discount housing in compensatory circumstances there is a precedent for taxing faculty housing. Traditional faculty housing programs have a completely different purpose from typical corporate perquisites, especially in light of the substantial rents charged and the educational objectives served by the programs.

The IRS also cites *Goldsboro Christian Schools, Inc.* v. *United States,* 78-1 USTC 9191 (E.D.N.C. 1977) and *Bob Jones University* v. *United States,* 670 F.2d 167 (Ct. Cl. 1982) for the proposition that there is a precedent for taxing faculty housing. *Goldsboro* and *Bob Jones* involved the provision of *free* housing to employees at institutions that the Supreme Court recently found not to be tax exempt because of their policies of racial discrimination. Neither *Goldsboro* nor *Bob Jones* support the IRS's position with regard to traditional faculty housing programs. Those cases are clearly distinguishable from traditional housing programs where reasonable rents are charged that reflect the educational institution's costs and the value of the housing to the employees. In *Goldsboro* and *Bob Jones* the housing was provided free of charge to the employees, the housing was obviously provided at substantial expense to the employer, and in some instances employees who did not live in the free housing were offered a cash stipend. The employees in those cases also received other substantial benefits such as free utilities, free food, free medical care and free insurance. In these circumstances, the provision of free housing and other benefits necessarily relieved the employee of personal expenses and this involved taxable compensation. Therefore, the result in *Bob Jones* and *Goldsboro,* although not surprising, has no direct bearing on the applicability of the fringe benefit moratorium to a tax-exempt educational institution which charges reasonable rents reflective of costs, and which does not offer a cash alternative.

Congress recognized when it passed the fringe benefit moratorium that Section 61 of the Internal Revenue Code and the Regulations thereunder provided on their face for the taxation of every item provided in kind by an employer at less than its value. However, Congress also recognized that despite this principle the IRS in fact has not challenged certain fringe benefit practices, and the moratorium was intended to maintain that status quo until Congress itself could review the entire fringe benefit area. *See* House Report No. 95-1232. Thus, for example, while the IRS would tax a top salesman who was awarded an airline trip to Hawaii by his employer, the IRS had not taxed widespread programs for providing free or virtually free airline travel to flight attendants. The latter benefit, which involves special circumstances such as the fact that the employer did not incur any substantial marginal costs, is thus protected by the fringe benefit moratorium while the former benefit is not. Just as the flight attendant who receives free travel is distinguishable from the salesman who receives free travel as bonus compensation, traditional faculty housing programs are distinguishable from housing provided in the business context or provided free of charge at Bob Jones University or at Goldsboro Christian Schools, Inc. Indeed, traditional faculty housing programs are not unlike the provision of free travel to flight attendants in that in both cases the benefit is provided at little or no unreimbursed cost to the employer.

Finally, as noted above, the IRS itself has applied a cost measure for so-called fringe benefits, specifically with respect to cafeteria meals. To seek to apply a commercial market value measure to traditional faculty housing programs is therefore a change in IRS practice which Congress sought to prevent when it enacted the fringe benefit moratorium.

D. PROPOSED LEGISLATIVE SOLUTION

We propose that Congress remedy the inequity created by the IRS' attempts to override *Central Illinois* and the fringe benefit moratorium and to collect retroactive withholding taxes from educational institutions maintaining traditional faculty housing programs.

First, as to the past and present, Congress should clarify the application of the fringe benefit moratorium to traditional faculty housing programs, so as to prevent the imposition of retroactive withholding taxes. H.R. 677, introduced earlier this year by Congressmen Shannon and Conable, and now pending before this Subcommittee, would have this effect (providing for tax only in certain instances with respect to excess costs not fully recovered by rents).

Second, if the fringe benefit moratorium is extended beyond December 31, 1983 in order to provide additional time for Congress to reach a comprehensive resolution of the fringe benefit area, Congress should make it clear that the moratorium applies to traditional faculty housing programs, both as to the past and for any extension period.

Third, for the future, Congress should make it clear through legislation that traditional faculty housing programs do not give rise taxable income or wages subject to withholding as long as the institution's costs are recovered. We propose that H.R. 677 be amended to provide such a solution. Such amendment would exclude the value of "qualified campus lodging" from gross income. Qualified campus lodging would mean lodging on or near campus furnished at or above cost by an educational institution to an employee, his spouse or any of his dependents. If the rent charged is less than the institution's cost of providing the lodging then the difference between the cost and the rent would constitute income to the employee.

E. REVENUE IMPACT

I know that Congress is interested both in clarifying the fringe benefit area and uncovering new sources of tax revenues which may be available to respond to our growing federal deficit. Traditional faculty housing programs, however, do not provide a source for revenue. The alternative for educational institutions is to sell off the housing; the resulting cost to the Federal Government from homeowner deductions for mortgage interest and property taxes would in all likelihood exceed the amount being sought by the IRS in these cases.

F. CONCLUSION

I urge you, on behalf of Amherst College, Smith College, Wellesley College, Wesleyan University and the many institutions and individuals represented by the educational associations listed above, not to allow this inequitable situation created by the Internal Revenue Service to continue. Smith, in its effort to provide excellence in all aspects of education, has maintained its faculty housing program for over half a century. The continuing need for excellence in American education, an excellence that must exist both within and without the classroom, calls for your support of such programs rather than for their destruction at the hands of the Internal Revenue Service.

Mr. DORGAN. Ms. Conway, thank you very much for that testimony.

Would you like to identify who on the panel would like to speak next? And might I ask if you can to summarize your remarks as best you can? We will include your entire statements in the record.

Ms. CONWAY. Yes. Speaking next, Mr. Chairman, is Mr. Alfred D. Sumberg, associate general secretary of the American Association of University Professors.

Mr. DORGAN. Mr. Sumberg.

STATEMENT OF ALFRED D. SUMBERG, ASSOCIATE GENERAL SECRETARY, AMERICAN ASSOCIATION OF UNIVERSITY PROFESSORS

Mr. SUMBERG. Thank you, Mr. Chairman, members of the committee.

I am Alfred Sumberg, associate general secretary, American Association of University Professors.

Our membership includes many of the faculty at institutions which have housing available to faculty. I have a much longer statement which I understand will be included in the record, and I just want to summarize that statement at this point.

Our association supports enactment of H.R. 677. We believe the legislation should be amended in accordance with Congressman Shannon's recommendation to apply it prospectively as well as retroactively.

Faculty members who rent college housing are frankly puzzled by the efforts of the IRS to tax them or their institutions because of the rentals they pay to the institutions. This is not free housing. Faculty are not required by their institutions to live in this housing. Most of the faculty housing has been in existence for many decades, indeed, as Mr. Stark mentioned earlier from the time of Mr. Chips. In some instances it precedes Mr. Chips by many years. It was housing constructed on college-owned property in order to serve an important educational purpose; namely, to encourage students to be part of a collegial or academic environment that brought students and faculty together for hopefully spirited discussions outside the formal classroom.

It is a concept as old as higher education itself, and it is something most faculty desire to participate in. We understand how important this extension of the classroom is in the lives and careers of our students.

The fact that the institution has available housing normally proximate to the campus makes this part of the education process more possible, and hopefully more productive.

I want to emphasize, Mr. Chairman, that the faculty pays substantial rents. The average faculty salary in academic year 1982–83 was $27,430. Between 1971 and 1982 faculty salaries declined in real income by 20.7 percent.

For faculty the rental of any housing, including college-owned housing, is a substantial percentage of their disposable income, and as real estate values rose in the 1970's, faculty, like many Americans, found themselves priced out of the real estate market. Thus, the availability of college-owned housing enabled its faculty to pay the direct cost of housing without any subsidy either by the institution or Government, and at the same time faculty can fulfill their responsibilities to students outside the formal classroom.

As you know, Mr. Chairman, we support enactment of a fringe benefits bill before the current moratorium ends on December 31. We appreciate the actions of this subcommittee and the full committee in that matter. We support enactment of an amended H.R. 677 during this same time schedule, but if there is insufficient time for floor action on both bills, we would urge that faculty housing be incorporated into the bill extending the moratorium.

Again, we prefer enactment of legislation rather than the continuing uncertainty of the future of these programs.

I thank you for the opportunity to appear before you today, and I welcome any questions you may have.

[The prepared statement follows:]

STATEMENT OF ALFRED D. SUMBERG, AMERICAN ASSOCIATION OF UNIVERSITY PROFESSORS

My name is Alfred D. Sumberg. I am Associate General Secretary of the American Association of University Professors, which strongly supports enactment of H.R. 677.

I also want to note at the outset that we support amending this legislation to apply a cost-base standard to taxation of faculty housing programs in the future. Congressman Shannon has proposed that such an amendment be added during committee consideration of H.R. 667, and we are in complete agreement with that proposal.

I will briefly discuss several aspects of the faculty housing issue: First, the reason why it is irrational for the Internal Revenue Service to value faculty housing with reference to the commercial rental market. Second, the absence of any formal attempt by the IRS, prior to the enactment of the fringe benefit moratorium, to tax faculty members or their employers because of the maintenance of faculty housing programs charging substantial rents. And third, the fact that the passage of H.R. 677 would not result in a significant cost to the Treasury.

The IRS has taken the position with several New England colleges and universities that any difference between the rent paid by a faculty member for housing and the rent that could theoretically have been obtained on the commercial rental market constitutes taxable wages to the faculty member. This position of the IRS is illogical with regard to those educational institutions charging substantial rents that approximate the cost of supplying the housing. When a university holds or acquires a block of housing on or near campus that it rents to its faculty members, it does so primarily for its own educational purposes: to create an extended campus community where faculty members and students are free to interact outside the classroom. It is a well known fact of collegial life that the educational importance of informal interchange between faculty and students—of the kind facilitated by the presence of faculty members living on or near campus—is often as great as the educational importance of classroom work. A faculty housing program simply helps prevent faculty members from being forced to live many miles away from the campus in order to find a neighborhood where commercial rents are within the reach of a professor's salary.

To allow theoretical commerical value to be the controlling standard is to accept the paradoxical and unfair situation in which a college or university with a large, attractive campus and numerous campus activities is responsible for raising property values and thus driving its faculty members away to distant, less expensive neighborhoods. Instead of asking what a business executive would be willing to pay to live in faculty housing, the relevant questions to ask when evaluating a faculty housing program are first, what does it cost the educational institution to provide the housing, second, what are the educational purposes being fulfilled by the housing program and third, what is the value of the housing to the faculty members? Unfortunately, these are not questions asked by the IRS.

The second issue I will address is the fringe benefit moratorium enacted by Congress in 1978 to prevent the IRS from altering its historical treatment of fringe benefits. Prior to the enactment of the moratorium the IRS had never maintained that the maintenance of a faculty housing program charging substantial rents constituted taxable wages to the faculty members. The IRS has attempted to obscure this fact by pointing to cases decided prior to the moratorium where, in isolated instances, a corporate employer provided discount housing to an employee. (See, for example, *International Artists, Limited,* 55 T.C. 94 (1970), where the Tax Court held that Liberace, the noted pianist, was in receipt of income when a corporation in which he held 74 percent of the stock allowed him to live in a house at a below-market rent.) Cases such as these, however, involving corporate perquisites unrelated to the business of the corporation, are simply not relevant to a faculty housing program that is designed to serve the educational purposes of a college or university.

The IRS has also argued that the fringe benefit moratorium does not apply to traditional faculty housing programs because in two cases it took the position that housing provided to faculty members constituted taxable income. (*Bob Jones University* v. *United States,* 670 F.2d 167 [83-1 USTC ¶ 9168] (Ct. Cl. 1982); and *Goldsboro Christian Schools, Inc.* v. *United States,* 79-1 USTC ¶ 9266 (E.D.N.C. 1978) *aff'd* by 4th Cir. Ct. of Appeals on 2/24/81 in an unpublished opinion.) Both these cases involved the provision of free housing to faculty members in situations distinct from traditional faculty housing programs where substantial rents are charged.

If a university provides free housing to its employees it is clear that a compensatory benefit is being conferred. If a university maintains a faculty housing program for its own educational purposes, however, and recovers most or all of the relevant costs, there is no obvious compensatory benefit. Although we believe the IRS position is legally untenable in that faculty housing programs have existed for decades without a murmur from the IRS, it is necessary to enact H.R. 677 to ensure that the IRS does not continue its efforts to tax participants in such faculty housing programs in direct contravention of a Congressional mandate.

The Third point that I would emphasize is that the enactment of H.R. 677 would have little or no revenue impact. If the IRS is allowed to continue its efforts to tax faculty housing programs, educational institutions would be forced to sell such housing to faculty members with a buy-back provision at the termination of employment. The mortgage interest and real estate tax deductions that would be generated by such a course of action would more than offset any revenue that the IRS can hope to raise by pursuing faculty housing programs.

In closing, let me emphasize that H.R. 677 is a good solution for the past and present, but it does not address the future. We believe that the bill would be significantly improved if it also provided similar protection for the future. The American Association of University Professors urges the passage of H.R. 677 as so amended.

Mr. DORGAN. Thank you very much.

Ms. Conway.

Ms. CONWAY. I would like to call next, Mr. Chairman, on Dr. Merle Allshouse, president of Bloomfield College, N.J.

STATEMENT OF MERLE F. ALLSHOUSE, PRESIDENT, BLOOMFIELD COLLEGE

Ms. ALLSHOUSE. Mr. Dorgan, and members of the Subcommittee on Select Revenue Measures, I want to say it is a pleasure and an honor to be with you to participate in some small way in the process of making what we hope will be effective legislation for our country.

I serve as president of Bloomfield College, a small, independent institution in New Jersey, and chairman of one of the major subcommittees of the National Association of Independent Colleges and Universities. I am pleased to be here on behalf of that organization, the American Council on Education and the other nine groups listed on the front page of this testimony.

Together, these associations represent more than 2,000 public and independent colleges and universities across the country. I will try to summarize my remarks that are published and address the two issues of great importance to higher education, H.R. 2568 and H.R. 677.

We are especially grateful to Congressman Shannon, the primary sponsor of both pieces of legislation. These represent his continuing efforts on behalf of higher education, which we honestly feel is our Nation's important resource.

H.R. 2568 would make permanent a current Tax Code provision scheduled to expire December 31 of this year. That current law provision, section 127 of the Internal Revenue Code, allows an employee to receive educational assistance from his or her employer without incurring taxable income.

The educational assistance provided by the employer is tax free to the employee only if the program is operated in compliance with several restrictions. The program may not, for example, discriminate in favor of highly compensated employees. In addition, the program may not include frivolous courses relating to sports, hobbies, games, and so forth.

I do not need to rehearse the history of this legislation, but I think it is important because it underscores that sometimes legislation enacted does good things.

Prior to 1978 the employee was frequently discriminated against by this legislation, particularly low income, minority, clerical and secretarial employees, and other persons who could not risk the possibility of not having their courses meet the requirements of the law. Therefore, we tended to find only those persons who were more highly placed in organizations and corporations took advantage of this program.

Not only that, the programs varied widely among different companies. It was possible, for example, for an employee not to be taxed on educational assistance in one company, to move to another business and find it no longer held. The law was not enforced uniformly from company to company or within IRS jurisdictions from one to another.

The job-related provision clearly resulted in a limited range of options available to individuals in lower level jobs, especially women and minorities, as opposed to those in managerial capacities where a broader range of nontaxable educational assistance was available to them.

The example cited of the study done by AT&T only illustrates the fact that under the previous provisions approximately 3 percent of employees were able to take advantage of these programs.

As part of the 1978 Revenue Act, Congress passed employee educational assistance legislation providing that certain qualified educational assistance programs would be tax free to employees. As a result of these changes, we now find through a recent study that over 4 percent, a tremendous gain in a short time, of Fortune 1,000 companies take part in these programs. Of 17 million workers covered by the survey, approximately 700,000 are taking advantage of these programs today.

In my own State of New Jezsey which is highly industrial and highly urbanized, we find that approximately 10 to 15 percent of the undergraduates in our independent institutions, on the basis of a survey done this fall, are engaged in this very program. In my own institution it is exactly 10 percent, which involves over 75 companies in New Jersey.

In Fairleigh-Dickinson University, the largest independent institution in our State, 4,327 students participate at the graduate level and 3,478 at the undergraduate level in this program.

In Congressman Guarini's district, which includes St. Peter's College, we find 1,150 undergraduate students are participating now in this program. At St. Peter's College we find the average participant is female, minority, and over 22 years of age.

Experience indicates that the job-related discrimination problems that existed before 1978 have been at least somewhat alleviated by the 1978 act provisions.

In addition to an extension of the tax code provision, we would encourage consideration of allowing educational assistance to be provided with a cafeteria plan or flexible program. Regulations released in early July of this year do not allow tuition assistance programs to be nontaxable if they are offered as alternatives to items included in gross income, such as wages. If that provision were to be deleted, corporations would be further encouraged to allow educational assistance in their cafeteria programs.

It is absolutely essential that Mr. Shannon's legislation be acted upon affirmatively in order to assure continued access to higher education for those involved in employee educational assistance programs.

On the subject of section 127 application to graduate students serving as research or teaching assistants at colleges and universities, I will defer to Mr. Allen Claxton of New York University who will provide testimony. We are appreciative of his efforts, and all of those associations who endorse these comments also endorse his.

I would also like to stress the importance of H.R. 677 which would allow as nontaxable certain faculty housing programs, and the testimony that Jill Conway has provided is endorsed by those organizations I represent today.

I was glad to appear, and I thank you for the opportunity.

[The prepared statement follows:]

Statement of Merle F. Allshouse, President, Bloomfield College, on Behalf of American Association of Community and Junior Colleges, American Association of State Colleges and Universitites, American Council on Education, Association of Catholic Colleges and Universities, Association of Jesuit Colleges and Universities, Association of Urban Universities, Council of Independent Colleges, National Association of Independent Colleges and Universities, National Association of Schools and Colleges of the United Methodist Church, National Association of State Universities and Land-Grant Colleges, and National University Continuing Education Association

Mr. Chairman and Members of the Subcommittee on Select Revenue Measures, my name is Merle Allshouse. I am President of Bloomfield College in Bloomfield, New Jersey, and I chair one of the advisory groups to the National Association of Independent Colleges and Universities (NAICU). I am pleased to be here today to testify on behalf of NAICU, the American Council on Education, and the other nine groups listed on the front page of my testimony. Together, these associations represent more than 2000 public and independent colleges and universities across the country.

I would like to address two issues of great importance to higher education—H.R. 2568, employee educational assistance, and H.R. 677, faculty housing. We are especially grateful to Congressman Shannon, the primary sponsor of both pieces of legislation, for his continuing efforts on behalf of the higher education community.

H.R. 2568 would make permanent a current tax code provision which is scheduled to expire December 31 of this year. The current law provision, Section 127 of the Internal Revenue Code, allows an employee to receive educational assistance from his or her employer without incurring taxable income. The educational assistance provided by the employer is tax-free to the employee only if the program is operated in compliance with several restrictions. The program may not, for example, discriminate in favor of highly compensated employees. In addition, the program may not include frivolous courses relating to sorts, hobbies or games.

Prior to 1978, an employee, in order to receive nontaxable educational assistance from his or her employer, must have undergone training related strictly to his or her current job. Compensation received for courses aimed at qualifying someone for a new job were taxable income to the employee. The result was that middle and upper management employees had a wide range of educational opportunities available to them while those in entry-level positions or those with few skills were unable to take advantage of such opportunities. An executive in a corporation had access to countless educational programs while the clerk or secretary had little chance for advancement since almost any type of course would be considered as non-job-related. Those at lower levels in the company were, in fact discriminated against.

Programs varied widely among different companies. It was possible, for example, for an employee being taxed on educational assistance in one company to move to another business and have taxes withheld by the new employer. The law was not enforced uniformly from company to company, or from one IRS jurisdiction to another. Since employees could not be certain that their courses would be deemed nontaxable, those making less income tended to play it safe and avoided taking a risk.

The "job-related" provision clearly resulted in a limited range of options available to individuals in lower level jobs, especially women and minorities, as opposed to those in managerial capacities who had a broader range of nontaxable educational assistance available to them. In fact, a 1978 study by the American Telephone and Telegraph Company indicated that although 93 percent of the large corporations surveyed offered help to employees to defray their higher education costs, the number of employees who took advantage of tuition remission programs was at a low of 3 percent in 1978. The primary reason cited for lack of participation was that tuition aid was limited to job-related courses. Clearly, the problem needed to be remedied.

As a part of the 1978 Revenue Act, Congress passed employee educational assistance legislation, providing that certain qualified educational assistance programs would be tax-free to employees. The new law served to remedy the discrimination problems apparent in corporate educational programs and increased the incentives for educational and career advancement. In addition, the law has provided substantial incentives for employers to provide employer-supported educational and training programs, evidenced by the increased use of such programs across the country. In 1983, the Council of Small Private Colleges received a grant from the Fund for Improvement of Postsecondary Education to study tuition benefit programs at all Fortune 1000 companies. Returns from 650 of those companies show that between 96 and 97 percent of the respondents offer some type of tuition assistance program to their employees. Of the 17 million workers covered in the survey, approximately 700,000 are taking advantage of the programs in one way or another.

In my own state of New Jersey, our colleges and universities utilize educational assistance programs as an integral part of their academic curriculum. At Bloomfield College, with an undergraduate population of 2600 students, 10 percent of our students are recipients of corporate employer assistance, allowing them access to educational opportunities which perhaps otherwise would not be available. Over this past year, those 260 students have represented seventy-five companies. If Congressman Shannon's legislation is not enacted before the end of this year, there will be a decidedly negative impact on the educational future of our students, as well as thousands more across the country. At Fairleigh Dickinson, the largest university in New Jersey, 74 percent of its graduate students—4,327 students—participate in some type of corporate educational program, and 3,470 undergraduate students (37 percent) participate in such programs. About 100 companies are represented by these students. Finally, at St. Peter's College in Jersey City, New Jersey, 1,150 undergraduates use the program. An interesting fact about St. Peter's is that of the students utilizing employer educational assistance, a high percentage are female heads-of-households or males over age 22 with families. That experience indicates that the job-related discrimination problems that existed before 1978 have been at least somewhat alleviated by the 1978 Act's provisions.

In addition to extension of the tax code provision, we would encourage consideration of allowing educational assistance to be provided with a "cafeteria" plan or flexible program. Regulations released in early July of this year do not allow tuition assistance programs to be nontaxable if they are offered as alternatives to items included in gross income, such as wages. If that provision were to be deleted, corporations would be further encouraged to allow educational assistance in their cafeteria plans.

It is absolutely essential that Mr. Shannon's legislation, H.R. 2568, be acted upon affirmatively in order to ensure continued access to higher education for those involved in employee educational assistance programs.

On the subject of the role of Section 127's application to graduate students serving as research or teaching assistants at colleges or universities, I defer to Mr. Alan Claxton of New York University, who will testify on the next panel. We are appreciative of Mr. Claxton's efforts in that area, and the associations I am here to represent fully endorse his statement and comments on graduate students.

I would also like to stress the importance of H.R. 677, which would allow as nontaxable certain faculty housing programs, so long as those colleges involved charge a reasonable rent to employees. Many of our colleges have long-standing faculty housing programs of great importance to their campus. The IRS has threatened to charge as income to the faculty member the difference between rent charged and the fair rental value of such housing. We think that inappropriate and urge passage of H.R. 677. Jill Conway, President of Smith College, will elaborate on that point and again, the associations I represent endorse her statement.

Finally, Mr. Chairman, I appreciate the opportunity to appear before this Subcommittee and ask that you recommend favorable consideration of both employee educational assistance and faculty housing.

Mrs. **Kennelly** [presiding]. Thank you, Dr. Allshouse.

Ms. Conway, who is your next speaker?

Ms. **Conway**. Madam Chairman, I think this concludes our testimony on H.R. 677, and there is a separate panel here to deal with H.R. 2568.

Mrs. **Kennelly**. Dr. Conway, what does it mean for universities to have their tax liability backdated? How serious a problem is this?

Ms. **Conway**. For my institution the total retroactive liability would be around $400,000. We are a relatively small institution. At the time the IRS first conducted this study we had 120 faculty in college housing. We now have about 83 because we do in fact already have some vacancies in our housing because the rents are already too high for our faculty. That gives us a 10-year liability of that order.

For many other institutions it would be much, much higher. For the four that I represent this afternoon the retroactive liability is about $2 million.

Mrs. **Kennelly**. I am on the board of trustees of Trinity College in Hartford, Conn. That kind of money is not lying around at a school like Trinity. Is it lying around at a school like Smith?

Ms. **Conway**. No, indeed.

Mrs. **Kennelly**. I did not think so.

Congressman Moore.

Mr. **Moore**. No questions. Thank you.

Mrs. **Kennelly**. I would like to thank you all very much for appearing. I am sure this will be very helpful in our looking at the matter.

Ms. **Conway**. We thank you very much for the opportunity.

Mrs. **Kennelly**. I would like to take this occasion to say I have a statement from Wesleyan University on faculty housing which I will put in the record.

[The prepared statement of Wesleyan University follows:]

STATEMENT OF COLIN G. CAMPBELL, PRESIDENT, WESLEYAN UNIVERSITY, MIDDLETOWN, CONN.

Mr. Chairman, Wesleyan is a small university that takes great pride in offering an excellent liberal arts program with instruction by an outstanding faculty in a stimulating, congenial environment. Like Amherst, Smith and Wellesley Colleges, Wesleyan makes every effort to encourage collegiality among its faculty and informal contact between student and faculty outside of the classroom and laboratory. We do this so that our communities will be interesting places to live and work and our students will have the greatest variety of opportunities for intellectual and personal growth.

An important aspect of our efforts to foster a lively community where faculty actively participate in a wide range of campus activities is the opportunity for the faculty to live near the campus. In Middletown, Connecticut where Wesleyan is located, such housing for faculty would not be available unless the University owned and rented properties to faculty.

I want to emphasize that the institutions do not provide free housing; typically rentals cover the cost of maintenance, local property taxes and other institutional expenses. Furthermore, by acquiring houses as they come on the market, an institution allows for eventual expansion if and when the need exists without disrupting the neighborhood.

The Internal Revenue Service, we believe, is wrong to maintain that when a college rents houses to faculty for less than it might receive from renters outside the institution, the difference in rate constitutes "income" for the renter, and the college should withhold taxes on its. We contend that by providing rental housing for faculty the University is filling an important and legitimate educational need.

As you know, we were unsuccessful in our efforts to seek legislative relief for our institutions in the last session of Congress. We therefore urge you to recommend to the full Ways and Means Committee and to the House of Representatives that the rent charged for faculty housing be exempt from taxation. Failing this we urge that the Committee at a minimum recommend that the Ways and Means Committee and the House clarify that the fringe benefit moratorium (P.L. 95-427) which is due to expire on December 31, 1983 applies to faculty housing programs such as Wesleyan's program and those of other New England colleges.

Mrs. **KENNELLY**. The next panel will be New York University, Allen E. Claxton; University of Santa Clara, Kenneth Haughton, dean, School of Engineering, accompanied by Sam Murray, office of Federal taxation, Arthur Andersen & Co.; National University Continuing Education Association, T. Benjamin Massey, chancellor, University College, University of Maryland.

Mr. Claxton, would you be so kind as to begin? And I do want to mention that all testimony submitted will be printed in full in the record if you want to summarize. If you do not, that is up to you.

STATEMENT OF ALLEN E. CLAXTON, SENIOR VICE PRESIDENT FOR FINANCE, NEW YORK UNIVERSITY, ACCOMPANIED BY JACK MYERS, COUNSEL

Mr. **CLAXTON**. Thank you, Madam Chairperson.

I will read a brief statement, but also, with your permission, I will include a statement for the record.

I am Allen E. Claxton, senior vice president for finance, New York University. I thank the committee members for providing an opportunity to express my institution's strong support for the passage of H.R. 2568, which has been introduced by Congressman Shannon.

Dr. John Brademas, president of New York University, asked me to personally convey his warmest greetings to his personal colleagues in the House. He wishes he could be with you today.

Further, I wish to express my sincere gratitude to Congressman Rangel for his consideration and his efforts in these matters.

At the outset I would urge you to make H.R. 2568 permanent. The changes to section 127 enacted in 1978 make the program especially helpful to expand educational opportunities for women, members of minority groups, and unskilled workers. However, my purpose in testifying today is to ask the committee to make clear that IRS section 127 is intended to exempt from taxation the tuition grants and remissions given for graduate courses to graduate assistants, teaching assistants, research assistants, and similar graduate students who exhibit outstanding qualifications.

The need to make clear this intent is because a record has yet to emerge regarding how the Internal Revenue Service will interpret implementing regulations to 127 which only recently were adopted.

We would note that the tuition remission grants and remissions given for graduate courses to graduate assistants, teaching assistants, and similar students are presently not taxed. Under section 503 of H.R. 4170, which has been reported by the Ways and Means Committee, education at the graduate level will no longer be excluded as a qualified tuition reduction because the bill applies only with respect to education at the elementary, secondary, and undergraduate levels.

Because of the services rendered to New York University and other universities by graduate assistants and similar students, the tuition remission or grants for the students may become taxable unless they are otherwise excluded under section 117 or another section of the code.

Based upon our examination of our own students, it would appear that only approximately 20 to 30 percent could continue to be excluded under section 117(b) because they are candidates for a degree, and the services they render are required by the institution to satisfy the requirements for the degree.

The balance, or approximately 70 percent, would be subject to taxation unless the program qualifies under 127. The principal condition of this section is that the grantees be found by the Secretary to belong to a classification of employees which does not discriminate in favor of employees who are officers or highly compensated.

Clearly, these students are by no means highly compensated, and we would ask the committee to explicitly recognize this reality for purposes of interpreting section 127.

From a review of the report of the Committee on Ways and Means concerning H.R. 4170, there are indications that the committee expects that tuition remission for graduate education for this category of students would be excludable under the present law provisions applicable to section 127.

We believe that appropriate legislative clarification by the committee of this intent would assure that educational benefits to these students would continue to be tax-free.

I indicate my institution's strong support for H.R. 2568 and urge that the committee recognize the exclusion from taxation thereunder of graduate level tuition remission or grants to certain graduate assistants, teaching assistants, research assistants, and similar graduate students.

Thank you.

[The prepared statement follows:]

STATEMENT OF ALLEN E. CLAXTON, SENIOR VICE PRESIDENT FOR FINANCE, NEW YORK UNIVERSITY

Mr. Chairman and Members of the Subcommittee, I am Allen E. Claxton, senior vice president for finance, New York University. I thank the committee members for providing an opportunity to express my institution's strong support for the passage of H.R. 2568 which has been introduced by Congressman Shannon. Dr. John Brademas, president of New York University asked me personally to convey his warmest greetings to you, his former colleagues. He wishes that he could be with you today. Further, we wish to express our sincere appreciation to Congressman Rangel for his efforts on these matters.

H.R. 2568 would make permanent the provisions of section 127 of the Internal Revenue Code which would otherwise expire at the end of this year. IRC section 127 provides that the taxable income of an employee does not include amounts paid or expenses incurred by an employer for educational assistance to an employee subject to conditions which are set forth therein.

At the outset I would urge the committee to make the provisions of IRC section 127 permanent. This law encourages employees to take advantage of opportunities for self-improvement provided by their employers. The changes to IRC section 127 enacted in 1978 make the program especially helpful to expand educational opportunities for women, members of minority groups and unskilled workers.

However, my purpose in testifying today is to ask the committee to make it clear that IRC section 127 is intended to exempt from taxation the tuition grants and remissions given for graduate courses to graduate assistants, teaching assistants, research assistants and similar graduate students who exhibit outstanding qualifications. (See appendix A for description.) The need to make clear this intent is because a record has yet to emerge regarding how the Internal Revenue Service will interpret implementing regulations which have only recently been adopted.

We would note that the tuition remission grants and remissions given for graduate courses to graduate assistants, teaching assistants, research assistants and similar graduate students are presently not taxed from Federal income tax as scholarships under IRC section 117. Under section 503 of H.R. 4170, which has been reported by the Ways and Means Committee, education at the graduate level will no longer be excluded as "a qualified tuition reduction" because the bill applies only with respect to education at the elementary, secondary or undergraduate levels. Because of the services rendered New York University, the tuition remission or grants for graduate students will become taxable unless they are otherwise excluded under IRC section 117 or another section of the Internal Revenue Code.

Based upon our examination of our students, it would appear that approximately 20-30 percent could continue to be excluded under IRC section 117(b) because they are candidates for a degree and the research, teaching or other services are required by the institution to satisfy existing specifically stated requirements for the degree and equivalent services are required of all candidates for that degree. (See Revenue Ruling 75-280, 1975-2, C.B. 47, appendix B.) The balance, or approximately 70 percent, would be subject to taxation unless the program qualifies under IRC section 127. The principal condition of this section is that the grantees be found by the secretary to belong to a classification of employees which does not discriminate in favor of employees who are officers or highly compensated employees. Clearly, these students are by no means highly compensated, and we would ask the committee explicitly to recognize this reality for purpose of interpreting IRC section 127.

From a review of the report of the Committee on Ways and Means concerning H.R. 4170, there are indications that the committee expects that tuition reductions for graduate education for this category of students I am describing would be excludible under the present law provisions applicable to IRC section 127. We believe that appropriate legislative clarification by the committee of this intent would assure that educational benefits to these students will continue to be tax free.

I again indicate my institution's strong support for H.R. 2568 and urge that the committee recognize the exclusion from taxation thereunder of graduate level tuition remission or grants to certain graduate assistants, teaching assistants, research assistants and similar graduate students who are chosen from graduate students who exhibit outstanding qualifications. And, finally, allow me once again to express my appreciation to you, Mr. Stark, for your interest in this issue, for holding this hearing to give us an opportunity to express our views, and for your support.

APPENDIX A

New York University makes grants or remissions for all or part of the tuition for courses at the graduate or post-graduate level to the teaching assistants, teaching fellows, graduate assistants, teaching associates and research assistants (as defined below) or graduate students meeting the same requirements under other titles.

Teaching Assistant (TA) is applicable to a person temporarily attached to the University in a teaching capacity whose successful graduate study or field experience shall have demonstrated a special aptitude for the duties assigned.

The titles Teaching Fellow and Graduate Assistant are applicable to graduate or post-graduate students pursuing prescribed programs of study at the institution who, because of outstanding qualifications, are appointed to part-time teaching duties concurrent with their academic programs.

The title Teaching Associate may be applied to a person carrying a full teaching loan who may also be taking courses in certain specified programs.

Research Assistant—A graduate degree candidate fully committed to a program of study and research. The stipend varies from school or department, depending on duties. Generally, the Research Assistant does not teach but performs research responsibilities in laboratories and other types of facilities.

APPENDIX B

(Excerpt from Revenue Ruling 75-280, 1975-2 C.B. 47)

"In the instant case since (1) the taxpayer was a candidate for a degree at an educational institution, (2) the taxpayer performed research, teaching, or other services for the institution that satisfied then existing specifically stated requirements for the degree, and (3) equivalent services were required of all candidates for the degree, the research services shall not be regarded as part-time employment in accordance with section 117(b)(1) of the Code.

"Under these circumstances the Internal Revenue Service will assume that the amounts paid or allowed were for the primary purpose of furthering the education and training of the recipients in their individual capacity. The Service, however, *will not* assume that the primary purpose test has been satisfied *to the extent that* the taxpayer performs services in excess of those necessary to satisfy degree requirements. Nor will it assume that the primary purpose test has been satisfied if (1) the taxpayer performs research, teaching or other services for a party other than the educational institution (see *Elmer L. Reese, Jr.*, 45 T.C. 407 (1966), *affirmed per curiam*, 373 F.2d 742 (4th Cir. 1967)); (2) the grant is made because of past services or is conditioned on, or subject to an understanding with respect to, future employment or other requirements, including services in excess of those necessary to satisfy degree requirements; or (3) the degree requirements, or the nature and extent of the work that is approved as satisfying the degree requirements, are not reasonably appropriate to the particular degree."

Mrs. KENNELLY. Thank you very much, Mr. Claxton.

Mr. Haughton.

STATEMENT OF KENNETH HAUGHTON, DEAN, SCHOOL OF ENGINEERING, UNIVERSITY OF SANTA CLARA, ACCOMPANIED BY SAM MURRAY, OFFICE OF FEDERAL TAXATION, ARTHUR ANDERSEN & CO.

Mr. HAUGHTON. Thank you, Madam Chairman and members of the subcommittee.

The University of Santa Clara is a small private school in California. We respectfully seek your support for H.R. 2568, the extension of the employee educational benefit legislation.

The University of Santa Clara is typical of hundreds of other colleges and universities in this Nation which are providing education to students under employer-provided tuition assistance programs.

What sets Santa Clara apart from other institutions, however, is its location. We are situated in the midst of Silicon Valley. In fact, most of the companies you think of as Silicon Valley are within about 1 mile of our campus.

The university has developed a highly responsive curriculum to those companies, and the employees of these industries have responded in an unprecedented number as far as our graduate programs are concerned in the School of Business, the School of Engineering, and a few in the School of Law.

We find about 80 percent of all of the graduate students in the MBA program and the graduate engineering program attend classes with tuition paid by their companies. Those included whose tuition is paid are about 763 MBA students who attend evening classes, and about 1,200 engineering students who attend early morning classes from 7 to 9 a.m. Nearly all of these students work full-time. They come from, at last count, over 400 companies around us. A list of these companies is included in my testimony.

At this hearing I am joined by Samuel Murray, a representative of Arthur Andersen, one of the many firms committed to encouraging their employees to take advantage of the benefits provided by this legislation.

As dean of the School of Engineering at the University of Santa Clara, having come to that position from the IBM Corp., where I was director of product development laboratories, first in Lexington, Ky., and more recently in San Jose, Calif., I can now speak as a member of academe as to the importance of this measure and can also attest to the importance of such legislation to business and industry.

I believe Congress was extremely wise and farsighted in passing the original law which excludes from taxable income any tuition paid by an employer to cover the education of an employee.

The United States has a major crisis at the present time, and we are struggling in productivity and quality issues in this age. We are pushing to catch up with the international competition; for instance, in engineering, Japan and Germany—West Germany has a higher percentage of engineers in their work force. It corresponds favorably to their share of world trade and their increasing productivity during recent years.

As a matter of fact, as a side comment in 1979, 37 percent of the college graduates in West Germany were engineering graduates; 21 percent in Japan were engineering graduates; in the United States 5.8. There is an enormous gap. It is, therefore, critical we train professionals in engineering, marketing, and business practices to meet these foreign challenges.

New technology is being introduced every day in Silicon Valley, and each new technological development is accompanied by a need for new, highly trained workers. This legislation permits many workers who would otherwise find it economically infeasible to attend college to upgrade their skills and join the upward mobility of workers.

The private sector has demonstrated its firm commitment to the education of its employees. We have received countless letters from employers of our students who are concerned they may not be able to continue the employee educational assistance should section 127 be allowed to lapse. Management and employees agree that the creativity and productivity of the staff has been enhanced by the educational experience provided by the current legislation. And I might add that these students from the workplace have brought an added dimension to the classroom. Their practical knowledge of industry and work situations enriches the educational experience of all students. They also stimulate the faculty to explore new theories and develop new technology.

The university agrees with the employers that everyone will benefit from the proposed legislation—the employees, the employers, the university, and in the end the nation's economy.

Thank you for the opportunity to express my views.

[The prepared statement follows:]

STATEMENT OF KENNETH HAUGHTON, DEAN OF THE SCHOOL OF ENGINEERING, THE UNIVERSITY OF SANTA CLARA

Mr. Chairman, members of the Subcommittee on Select Revenue Measures. The University of Santa Clara respectfully seeks your support for H.R. 2568, the extension of the Employee Education Benefit legislation.

The University of Santa Clara is typical of hundreds of other colleges and universities in this nation which are providing education to students under employer-provided tuition assistance programs. What sets the University of Santa Clara apart from other institutions, however, is its location. Situated is the midst of Silicon Valley, long-acknowledged as the center of the high technology revolution, the University has developed a curriculum highly responsive to the needs of neighboring industries.

And the employees at these industries have responded in unprecedented numbers by taking advantage of the tuition benefits offered by their employers to enroll in the School of Business, the School of Engineering, and a few in the School of Law.

We now find that nearly 80% of all graduate students in the MBA program and the graduate engineering programs at the University attend classes with tuition paid by their companies. This includes 763 MBA students most of whom attend evening classes, and approximately 1,200 engineering students, many of whom attend the "early-bird" sessions beginning at 7:00 a.m. Nearly all of these students work full time, in addition to their educational pursuits. They come from 404 large, medium, and small businesses in our region. A list of the sponsoring companies is being submitted for your information.

At this hearing I am joined by Samuel Murray, a representative of Arthur Andersen, one of the many firms committed to encouraging their employees to take advantage of the benefits provided by this legislation. As Dean of the School of Engineering at the University of Santa Clara, having come to that position from the IBM Corporation, where I was Director of Product Development Laboratories first in Lexington, Kentucky, and more recently in San Jose, I can now speak as a member of academe as to the importance of this measure and can also attest to the importance of such legislation to business and industry. We believe Congress was extremely wise and far-sighted in passing the original law, which excludes from taxable income any tuition paid by an employer to cover career education for an employee.

This is the age of technologies expansion and global competition. For instance, in my field, Japan's and West Germany's high percentage of engineers in the work force corresponds favorably to their growing share of world trade and their increasing productivity during the past two decades. It is therefore critical that we train professionals in engineering, in marketing, and in business practices to meet these foreign challenges. New technology is being introduced every day in Silicon Valley, and each new technological development is accompanied by a need for new highly-skilled workers. This legislation permits many workers who would otherwise find it economically unfeasible to attend college, to upgrade their skills and join the upward mobility of workers.

The private sector has demonstrated its firm commitment to the education of its employees. We have received countless letters from employers of our students who are concerned that they may not be able to continue employee educational assistance should Section 127 be allowed to lapse. Management and employees agree that the creativity and productivity of the staff has been enhanced by the educational experience provided through the current legislation.

I might add that these students from the work-place have brought an added dimension to the classroom. Their practical knowledge of industry and work situations enriches the educational experience of all students. They also stimulate the faculty to explore new theories and develop new technology.

The University agrees with the employers that everyone will benefit from the proposed legislation—the employees, the employers, the University, and, in the end, the nation's economy.

Thank you, Mr. Chairman, for the opportunity to express the views of the University of Santa Clara on this important legislation.

COMPANIES PARTICIPATING IN A COMPANY/EMPLOYEE TUITION REIMBURSEMENT PROGRAM

Abacus II; Acurex Corp.; ADAC Laboratories; Access Matric Corp.; Adaptec, Inc.; Activision; Adelphi Associates; Advanced Electronic Design; Advanced Research & Applications; Advent Systems; AG Associates; Aitus Corp.; AIM; Altos Computer Systems; Alza Corp.; Almaden Vineyards; American Food & Candy Co.; American Micro Systems; Advanced Microdevices; Amdahl, Corp.; AMPEX; AMP; ANTEK NA; Apple Inc.; Applied Material Inc.; Applied Technology; Argus Technology; Argo Systems; Armstrong World Industries, Inc.; Arthur Andersen & Co.; Arthur Young & Co.; Asgrow Sud Co.; ASK Computer Systems; Atari; AT&T Information Systems; Aucca Corp.; Avantek; Aydin; Aydro Microwave.

BAAG MD; B&L Floral Supply Co.,Banfield & Associates; Bank of America; Beckman Instruments; Bechtel; Beck K Labs; Bell Northern Research; Benson Inc.; Black Angus Enterprises; Blackburn Co.; Boschert Inc.; Bostol Labs; BND; BNR; BR Communications; Brian-Kangas-Foulk & Associates; Burroughs; Branson, IPC.

Calflower Exchange; California Device Inc.; California Eastern Labs; Calma Co.; Candilla Electronics; Central Church of Christ; Cermetek Miroelectronic; CF Air Freight Inc.; Churchill International; Clairol Inc.; Cogito Systems; Coherent Inc.; Community Research Institute; Control Data Corp.; Cooper Laboratories; County of San Mateo; Corvus Systems; Creegan & D'Angelo Inc.; Crocker Bank; Cromemco Inc.; Crosby Resources; Cushman Electronics; CSC; CTH Design Inc.

Dalmo Victor; Data Encore; Data Point; Data Products; Deha Inc.; Develco Inc.; Dexcel-Gould; Dictaphone Corp.; Digital Equipment Corp.; Direct Inc.; Digital Optics; Dow Chemical Co.; Dun & Bradstreet Computing; Doug Gotthoffer & Co.; Drydael Engineering Co.; Don L. Beck Associates; Dynabtte Business Computers; Dysan Corp.

Eastman Kodak; Eaton CPD; EG&G Reticon; E.I. Dupont; Electromagnetic Systems Laboratories; Electric Power Research Institute; EM Systems; EPRI; ESSI; Ethyl Visqueen; Equifax Service; Exar Integrated Systems; Exel Microelectronics; Epidy Inc.; Exxon Enterprises.

Facc Fairchild; Fairchild Camera & Instrument; Falco Data Products; Federal Express; Finnigan; First Interstate Bank; Flexible Interactive Business Systems; Ford Aerospace; Formaster Corp.; Fortune Systems Corp.; Four Phase Systems; Fox Marketing; Fox & Carskadon Financial Corp.; Friden Alcatel.

General Electric; G.T.E. Sylvania; General Instruments; Gen Rad; Gibbs & Hill Inc.; Gierger; Gilroy Foods; Gould; Granger Associates; Gregory M. Amico.

Haig Precision; Hawley & Peterson Architects; Harris/Farinon Lightwave; Healthtronics; Hewlett Packard Co.; Heald Institute of Technology; High Technology Management Association; Hughes Aircraft Co.; Humphrey Instruments; Humphreys College; Hung Chang Co.; Huntece Ready Inc.

ICS Electronics; Intelledex; IBAK Microwave; Imagic Inc., International Business Machines (IBM); Inpsych Inc.; Intel; Inter Design; International Memories; Intersil; Integrated Device Technologies; Inmac; Imperial Valet; Informantics; International Imaging.

Jetstream Systems; Jardin Insurance; Julliard Alpha Liquor Co.

Karavan Enterprises; KLA Instruments; Kevex Corp.; Kaiser Electronics; Kaiser Medical Center; Kelly Business Furniture; Kimtron Corp.; Kratos.

Landsing Corp.; LSI Logic; Lin & J International; Lockheed Missiles & Space Co.; Lipton, Thomas J., Inc.

Mc Kesson Corp.; Machine Intelligence; Margaux Controls; Marriott Corp.; Matheson; Measurex Corp.; Mast Immunosystems; Master Images, Inc.; Memorex Corp.; Micro Automation; Micro Electronics Corp.; Micro Power Systems; Media Technologies; Monolithic Memories Inc.; Momentum Computer Systems; Monsanto Corp.; Moore Systems; Motorola; Mohawk Data Science; Molecular Computer; MPI; MMT; Multaplex; Murpheus Lights; Magnetic Peripherials Inc.

MCA Corp.; NCR Corp.; NASA/Ames; Neider, LeRoy S. Esq.; National Semiconductor; Nelson Analytical; Nicolet Paratronics Corp.; Northern Telecon; Noviate Winery; Nu Tech Engineering.

Oktel; Olivetti, ATC; Omex; Onyx Systems; Orimetrix; Osborne Computers.

Pacific Gas & Electric (P.G.&E.); Pace Distributors; Pacific Marketing Association; Packetcabcr; Paul Masson; Pacific Coast Producers; Peterbilt Motors Co.; Perkin-Elmer; Peninsula Times Tribune; Pizza Time Theatre; Piiceon Inc.; Planar Microwave; Plantronics; Plaza Bank of Commerce; PMI; Power-Sonic Corp.; Pragmatic Design Corp.; Precision Monolithics; Prime Computer; Priam; Pyramid Technology.

Quadrex; Quantel International; Quantum; Qume.

Racal-Vadic; Ramtek; Rancho Laguna Seca Inc.; Raytheon; Rapicorn, Inc.; Raychem; Raymond Kaiser Engineers; Raytel Medical Imaging; RCI; Rockwell International; Rolm Corp.; Rudolph, Stetten, Inc.

San Francisco Redevelopment Agency; San Jose Mercury News; Santa Clara County; Santa Clara Valley Water District; SAT Engineers Inc.; School of Communication Electronics; Scientific Atlanta Inc.; Scientific Spectrum; Seaborn Development Inc.; Sea Gate Technology; Seeg Technology Inc.; Semi-Gas Systems; Sensyn; Serra Shopping Center; Shugart Associates; Sic Computer Research; Siemens; Sierra Circuile; Sierra Monitor Corp.; Si-Fab Corp.; Signal Science; Signetics Corp.; Silicon Graphics; Siliconix; Silverking Oceanic Farms; Singer Link Division; SK Labs; S. Levy; Smith Kline Diagnostics; Sohio Petroleum Co.; Solo Systems.

Southwall Corp.; Space Applications Corp.; Sony Technology Center; Spectra Physics; SRI International; Stancora Telecommunications, Inc.; Standard Oil Co. of California; Stanford Medical Center; Stanford Telecommunications Inc.; Stanford University; Star Graphics Arts Coin Co.; STC Computer Research; Stauffer Chemical Co.; Storate Technology; Structural Measurement Systems; Supertex Inc.; Supreme Co.; Swanton Berry Farms; Synapse Computer Corp.; Synertek; Syntex; Syre; Systematic Support Device Co.; System Control; System Industries Inc.; The Systems Center; Sytek; Syva.

Tab Products; Taliq Corp.; Tandem Computers; Tandy; Tektronix Inc.; Telecom Industries Corp.; Teledyne; Teleminix International; Telesensory Systems Inc.; Televideo Systems; Telmos; Texas Instruments; Triple M Co. (3M Co.); Triad Systems Corp.; Trilogy Systems; TRW Systems; Tudor Engineering Co.; T/W Systems Inc.; Tymnet Inc.; Tymshare.

Ultrasystems; Underwriters Laboratories; Unified Mortgage Co.; Unigard Insurance Group; United Energy Corp.; United Pumps; U.S. Air Force; U.S. Navy; United Technologies; University of California, Santa Cruz; University of Honduras; University of Santa Clara; Utah International Inc.

Valtex Associates; Varian Associates; Verbatim; Versatek; Vertacom Inc.; Viacom Systems; Victor Technologies; VII; Viking Freight Systems; Vitalink Communications; Visicorp; Vlasic Foods; VLSI Technologies Inc.; VSL; VTI.

Warner-Lambert Co.; Watkins Johnson; Wells Fargo Bank; Wertek; West Coast Photo & Electric; West Valley College; Western Business Computers; Western Electric; Westinghouse; Wilton Co.; Wollongong Group; Worcester Controls.

X-COR; Xerox Corp.; XLA; XMR Inc.; Xonics Imaging Inc.; Zentec Corp.; Zilog Corp.; Zita; Zoecon; and Zymos Corp.

Mrs. KENNELLY. Thank you very much, Mr. Haughton.

Mr. Benjamin Massey.

STATEMENT OF T. BENJAMIN MASSEY, CHANCELLOR, UNIVERSITY COLLEGE, UNIVERSITY OF MARYLAND, ON BEHALF OF NATIONAL UNIVERSITY CONTINUING EDUCATION ASSOCIATION

Mr. MASSEY. Thank you, Madam Chairman, for the opportunity to appear before you today.

My name is Ben Massey. I am chancellor of the University of Maryland University College, the campus of the university that serves over 70,000 nontraditional students every year.

I am pleased to meet with you today on behalf of the National University Continuing Education Association, a national nonprofit educational association representing 300 colleges and universities throughout the country, including most of the traditional land-grant universities.

These colleges and universities have programs that address the needs of nontraditional students, adults attending less than full-time, principally in the evening and on weekends, both off campus and on.

It is because of my familiarity with the needs of nontraditional students that I so firmly support H.R. 2568, the Employee Educational Assistance Act.

The Revenue Act of 1978 has worked. Since 1978 participation in our programs by minorities has doubled, and there has been a steady growth in participation by women. Today, women outnumber men.

It is increasingly important that employers, labor, government, and our Nation's educational institutions continue their partnership to encourage learning by all members of our society. One way to do this is to continue the support provisions which exempt employees from paying tax on educational assistance provided them by their employers.

In my testimony, Madam Chairman, I cite three societal trends that make this legislation more important. I commend them to you as bedtime reading.

H.R. 2568 serves as an important base for individuals, government, business, and labor to work together in this important endeavor. We encourage its continuation as a foundation on which to build further incentives for human resource development.

H.R. 2568, or its predecessor, was a piece of legislation passed before the terms "human resource development" and "displaced worker" and "retraining" became buzz words. In the face of all the legislative initiatives currently under way, I recommend we continue to support this very important first step as we develop additional ways to educate and train our population to meet the challenges of the future.

Thank you very much, Madam Chairman.

[The prepared statement follows:]

STATEMENT OF DR. T. BENJAMIN MASSEY, CHANCELLOR, UNIVERSITY COLLEGE, UNIVERSITY OF MARYLAND ON BEHALF OF THE NATIONAL UNIVERSITY CONTINUING EDUCATION ASSOCIATION

My name is Ben Massey. I am Chancellor of The University of Maryland University College, the campus of the University that serves over 75,000 non-traditional students each year. I am pleased to have the opportunity to meet with you today on behalf of the National University Continuing Education Association, a national nonprofit educational organization representing 300 colleges and universities throughout the country which have continuing education programs that address the needs of "nontraditional" students—adults and others attending less than full-time; in the daytime, in the evening and on weekends; off-campus and on; and learning via many methods including the media, correspondence instruction, and conferences and seminars.

It is because of my familiarity with the needs of "nontraditional" students that I so firmly support H.R. 2568, the Employee Educational Assistance Extension Act. The National University Continuing Education Association (previously known as the National University Extension Association) supported these legislative initiatives when they were included in the Revenue Act of 1978 and the reasons for that support have only escalated in the intervening years, both in reality and in the nation's consciousness. It is increasingly important that employers, government and our nation's educational institutions continue their partnership to encourage learning by all members of our society. One way to do this is to continue to support provisions which exempt employess from paying tax on educational assistance provided to them by their employers, even when the employees are involved in educational experiences that are not directly job-related. The societal trends are clear.

SOCIAL TRENDS

1. We are a learning society.—Not only are most people participating in learning throughout their adult lives, but also most of our social institutions now are engaged in the sponsorship of learning activities. Business and industry, labor unions, trade and professional associations, museums, libraries, voluntary organizations, and government agencies are functioning as "educators." Therefore, we have to view the traditional educational system as but one of many educational systems. We not only have to encourage flexibility in the existing system, we have to find ways to produce effective collaboration among and between systems. There are few better ways government can encourage business and industry to support the education of its employees than the tuition reimbursement programs now offered by thousands of firms across the nation that provide tax exempt educational assistance to employees. Employees are eligible to use their employee educational assistance for educational programs at our nation's institutions of higher education. There are hundreds of bills now floating through the Congress aimed at stimulating human resource development and training and retraining for workers. We already have in place IRS regulations resulting from the Revenue Act of 1978 (which would be extended by the Employee Educational Assistance Extension Act) which encourage business, labor, employees and institutions of higher education to work together to serve the educational needs of the individual in the way that the individual sees best.

2. We are entering a technological age.—We are moving from an industrial society to an information society in which high technology is both source and resource. Computers, telecommunications, and robotics are going to change—are already changing—almost every facet of our lives. Certainly, the workplace will be greatly affected by these new tools and our ability to use them. Already, the half-life of an engineer is five years. We will all need retraining and re-education. Secretaries, for example, will need to be trained in the art of managing information, not in how to type better. Increasingly, the development of our human resources is seen as the key to our economic survival. All workers in the future will need to work with the new tools we are developing at such a rapid rate. They demand of us flexibility, creativity, and the ability to synthesize information, to make decisions with incomplete information and to recognize complex patterns. These are the skills that are learned through a combination of on-the-job training and higher education experiences. They are also the kinds of skills we will all need to learn and should be supported to learn regardless of our position in the workplace.

3. We are an aging society.—Most people now will live into their 70s and 80s, and it is expected that the average life span will continue to increase. We need to encourage the continued growth and learning of our aging population and to harness their wealth of experience for the future. We cannot do too much of this. H.R. 2568 serves as an important base for individuals, government and business to work together in this important endeavor. We encourage its continuation as a foundation on which to build further incentives for human resource development.

From personal experience at the University of Maryland, I am proud to say that we have many programs of cooperation between the multitude of high tech firms in Maryland and the University. Among the most innovative is the Fairchild Scholar Program, which is making important contributions to the training of graduate engineers for fields that are in critical need of them.

I would therefore strongly recommend the passage of H.R. 2568. It is a piece of legislation that was passed before the terms "human resource development" and "displaced worker" and "retraining" became buzzwords. In the face of all legislative initiatives currently underway, I recommend we continue to support this very important first step as we develop additional ways to educate and train our population to meet the challenges of the future.

Mrs. KENNELLY. Thank you very much, sir.

Mr. Moore, any questions?

Mr. MOORE. I have none. Thank you.

Mrs. KENNELLY. Mr. Schulze.

Mr. SCHULZE. Thank you. I have no questions.

Mrs. KENNELLY. Has everyone testified that so wishes to at the table?

Thank you very much.

The next panel will appear on H.R. 2568: the United Automobile, Aerospace & Agricultural Implement Workers of America, Sheldon

Friedman; Institute of Electrical & Electronics Engineers, Dr. Russell Drew; Rockwell International Corp., M. Patrick Crotty, vice president, industrial relations; American Chemical Society, Dr. Warren Niederhauser, president-elect.

Mr. Friedman, would you lead off for us?

STATEMENT OF SHELDON FRIEDMAN, RESEARCH DIRECTOR, INTERNATIONAL UNION, UNITED AUTOMOBILE, AEROSPACE & AGRICULTURAL IMPLEMENT WORKERS OF AMERICA, UAW

Mr. **Friedman**. Thank you, Madam Chairperson. I appreciate the opportunity to present the UAW's views on the tax treatment of educational assistance benefits provided by employers.

We strongly urge the subcommittee to report favorably on H.R. 2568 and make permanent the current tax-exempt status of those benefits. At stake are the continuation and expansion of hundreds of programs to improve the education and skills of American workers. These programs not only help those directly involved, but the public at large benefits from higher productivity, a more dynamic economy and a more equitable society.

There has been unprecedented dislocation of American workers in recent years. Intensified international competition and grossly misguided Government policies have made more than 3 million workers victims of economic dislocation. While some of this job loss has been cyclical, the proportion of unemployed who have permanently lost their jobs is a record 53 percent in the current recession, far above the 37 percent registered during the 1973–75 recession.

In addition, as new technologies enter the workplace at a rapid rate, the skills of scores of thousands of active workers are quickly falling behind the demands posed by their new redesigned jobs.

Because of the UAW's concern about reemployment of our laid-off members and the uncertain future many currently employed members face, we have given training and retraining a high priority in collective bargaining.

In early 1982 we established important new joint training programs with the Ford Motor Co. and the General Motors Corp. among others. The goal has been to provide training, retraining and developmental opportunities for active and laid-off UAW members. For laid-off members this includes job-finding assistance; for active members it means assistance to enhance job security and upgrade skills.

The UAW-Ford programs began in the summer of 1982 with Ford's UAW-represented work force at the time down by some 90,000. Initial efforts were aimed at these laid-off workers.

The first program we implemented offered tuition assistance of up to $1,000 a year for qualifying laid-off workers so that they could pursue self-chosen education and training to improve their chances for reemployment either within or outside the corporation.

At General Motors our tuition refund and training efforts have also focused on laid-off workers to date with good results both in terms of participation as well as job placement. Very few people could have taken advantage of these education and training opportunities had the assistance they received been taxable. Most of the unemployed could not have afforded the further erosion of their income brought about by enrolling in a training or self-improvement course.

Our laid-off members are facing great financial hardship as confirmed by the finding of two recent surveys. One of them, conducted jointly by the UAW and the Social Welfare Institute at Boston College, found that 60 percent of a group of laid-off UAW members in New England remained unemployed as much as 27 months after their plants had closed. Their family income had been cut in half to about $200 per week.

Another study of UAW members found a similar situation. The New York State School of Labor and Industrial Relations at Cornell University recently examined the consequences of the Ford Motor Co.'s plant closing in Mahwah, N.J. Since the shutdown 2 years earlier, median family income of the more than 5,000 UAW members affected had fallen to less than half its prior amount, from $22,000 down to $10,400.

For the unemployed as well as people who enroll in training programs while holding a job, taxing those benefits would cut into their income at a time when they are already facing extra coursework-related expenses for food away from home, child care, an extra tank of gas, for example.

Groups in dire need of opportunity, such as women and minorities, would be far less able to cope with these tax laws and would fall even lower in the occupation and learning ladder.

The inexplicable conclusion is taxing educational assistance benefits would severely curb participation in such programs, especially those geared to the unemployment, to the detriment of those workers' chances for reemployment and career advancement.

Efforts already in place, including costly buildings and equipment, would be utilized far below capacity or not at all. The entire economy would be shortchanged as a result. Allowing the present regulation to expire would also be highly inequitable. We would return to a situation where only those at the higher end of the scale would enjoy tax-free education benefits.

The pre-1978 strict requirement that employer-reimbursed tuition assistance relate solely to present job responsibilities clearly worked against anyone outside a management position.

In addition, expiration would provide many American workers with a disincentive to invest in their own human potential in stark contrast to the incentives the Tax Code lavishes on business for investment in plant and equipment.

Worrisome high future Federal deficits are a concern, but they should be handled in a progressive and realistic way by restoring taxes on corporations and the wealthy. As a matter of revenue policy, taxation of educational benefits is woefully shortsighted. It makes much more sense to avoid penalizing education and training now and tax the resulting higher incomes in the future.

In conclusion, the UAW is very proud of the joint training and job development programs and other educational assistance we have negotiated for the benefit of our laid-off and active members. Taxation of employee educational assistance would place the programs in jeopardy. They would probably languish at low participation rates and might even eventually disappear.

Displaced and about to be displaced workers, women and minorities would be prime losers, and society at large would lose as well.

I urge you to preserve the current tax status of educational assistance benefits by supporting H.R. 2568.

Thank you.

[The prepared statement follows:]

STATEMENT OF SHELDON FRIEDMAN, RESEARCH DIRECTOR, INTERNATIONAL UNION, UNITED AUTOMOBILE, AEROSPACE & AGRICULTURAL IMPLEMENT WORKERS OF AMERICA, UAW

Chairman Stark, I appreciate the opportunity to present the UAW's views on the tax treatment of educational assistance benefits provided by employers. We strongly urge this Subcommittee to report favorably on H.R. 2568 and make permanent the current tax-exempt status of those benefits. At stake are the continuation and expansion of hundreds of programs to improve the education and skills of American workers. These programs do not only help those directly involved; the public at large benefits from higher productivity, a more dynamic economy, and a more equitable society. Enactment of H.R. 2568 is also desirable on tax equity and revenue policy grounds.

There has been an unprecedented dislocation of American workers in recent years. Intensified international competition and grossly misguided government policies have resulted in more than 3 million workers victimized by economic dislocation. Many of these workers are UAW members.

While some of the dislocation has been cyclical, the proportion of the unemployed who have permanently lost their jobs is at a record 53%, far above the 37% registered in the 1973-75 recession.[1] In addition, as computerized systems of different stripes and scope invade the workplace, the skills of scores of thousands of active workers are quickly falling behind the demands posed by the new, redesigned jobs.

Because of the UAW's concern about the availability of re-employment opportunities for our members and the uncertain occupational future that many currently employed members face, we have given training and retraining a high priority on our collective bargaining agenda. Early in 1982 we established important new joint training programs with the Ford Motor Company and the General Motors Corporation.

In both cases, the goal is to provide training, retraining, and developmental opportunities for active and laid-off UAW-represented workers. For laid-off members this includes job-finding assistance. For active members it means assistance to enhance job security and upgrade skills.

The UAW-Ford programs began in the summer of 1982. With Ford's UAW-represented workforce at the time down by 90,000 initial efforts were aimed at laid-off workers. The first program implemented offers tuition assistance up to $1,000 a year for qualifying laid-off workers so that they can pursue self-chosen education and training to improve their chances for re-employment within or outside the company.

In August of last year, brochures were mailed to 18,000 workers describing the tuition assistance program. The response was enthusiastic. So far, over 2,800 course enrollments have been approved and an average of 100 applications are coming in a week.

We already have the profiles of the first 600 workers who have participated in the plan. Over 50 percent chose two-year vocational education degree programs, almost all at community colleges. Of those who chose two-year vocational education programs some 57 percent chose electronics, robotics, or other technology-related course work. About 13 percent selected four-year college and university programs. People tended to select ambitious full-time course loads, with the plan paying approximately 95 percent of the average cost of tuition and compulsory fees.

The second UAW-Ford implemented program offers intensive, full-time retraining—generally technical in nature—which will lead to skill certifications in specific occupations. The first two projects, for welding and tool and die certifications, involved 72 laid-off workers from several Southeastern Michigan Ford plants. Forty-two recently graduated, and close to half already have found new jobs.

Other vocational retraining projects have been initiated at five Ford locations across the country—Sheffield, Alabama; San Jose, California; Nashville, Tennessee; and two metropolitan areas in Michigan—with 300 laid-off workers receiving training ranging from microwave technician to video production technician. Details on joint training programs we have negotiated at other companies, particularly at the General Motors Corporation, are spelled out in the attached statement, which I wish to submit for the record. At GM, our tuition refund and training efforts have also focused on laid-off workers with remarkable success in terms of participation as well as of job placement.

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[1] See "Monthly Labor Review," a U.S. Bureau of Labor Statistics publication, September 1983, p. 7.

Very few people could have taken advantage of these education and training opportunities had the assistance received been taxable. Most of the unemployed could not have afforded the further erosion of their income brought about by enrolling in a training or self-improvement course—even if that meant sacrificing the chance of a better job down the road.

Our laid-off members are facing great financial hardship, as confirmed by the findings of two recent surveys. One of them, conducted jointly by the UAW and the Social Welfare Research Institute at Boston College, found that 60% of a group of laid-off UAW workers in New England remained unemployed as much as 27 months after their plants had closed. Their total family income had been cut in half to about $201 a week. Another study of UAW members found a similar situation. The New York State School of Industrial and Labor Relations of Cornell University recently studied the consequences of the closing of a Ford Motor Company assembly plant in Mahwaw, New Jersey. Since the shutdown two years earlier, median family income of the 5,000 UAW members affected had fallen to less than half, from $21,600 to $10,400. Incidentally, in recognition that laid-off workers are less likely to have "up-front" money for tuition, the UAW-Ford program provides pre-paid tuition.

Moreover, for the umemployed as well as for people who enroll in training programs while holding a job, taxing those benefits would cut into their income at a time when they are already facing extra coursework-related expenses—for food away from home, child care, and/or an extra tank of gas. Groups in dire need of training opportunities, such as women and minorities, would be far less able to cope with these tax costs, and would fall even lower in the occupation and earnings ladder.

The inescapable conclusion is that taxing educational assistance benefits would severely curb participation in education and training programs, especially those geared to the unemployed, to the detriment of workers' chances for employment and career advancement. Efforts already in place, including costly buildings and equipment, would be utilized far below capacity or not at all. The entire economy would be shortchanged on account of it.

Allowing the present regulation to expire is also inadmissible on equity grounds. We would return to a situation where only those at the higher end of the scale would enjoy tax-free educational benefits: the pre-1978 strict requirement that employer-reimbursed tuition assistance related solely to present job responsibilities clearly worked against anyone outside of management positions. In addition, expiration would provide many American workers with a disincentive to invest in their own human potential, in stark contrast to the incentives that the tax code lavishes on business for investment in plant and equipment.

Taxation of educational assistance cannot be defended on grounds of revenue loss: its current impact on the deficit is very small. In any case, worrisome high future federal deficits should be handled in a progressive and realistic way, by restoring taxes on corporations and on the wealthy. Indeed, as a matter of revenue policy, taxation of educational benefits seems woefully shortsighted. It makes much more sense to withhold disincentives for education and training now, and tax the resulting higher incomes in the future; in effect, we are not talking about tax exemption as much as about tax deferral, on higher future earnings.

In conclusion, we in the UAW are very hopeful about the joint/training programs and other educational assistance we have negotiated for the benefit of our laid-off and active workers, and encouraged by the results in evidence so far. Taxation of employees' educational assistance would place these programs in jeopardy: they would be guaranteed to languish at a low participation level and eventually disappear. Displaced and about-to-be displaced workers, women an minorities would be prime losers, and society at large would lose mightily as well. I urge you to preserve the current tax status of educational assistance benefits by supporting H.R. 2568.

STATEMENT OF SHELDON FRIEDMAN, RESEARCH DIRECTOR, INTERNATIONAL UNION, UNITED AUTOMOBILE, AEROSPACE & AGRICULTURAL IMPLEMENT WORKERS OF AMERICA (UAW)—SEPTEMBER 16, 1983, BEFORE THE JOINT ECONOMIC COMMITTEE

Thank you for this opportunity to present the UAW's views on the nature and magnitude of the problems facing structurally unemployed workers, and the inadequacy of current public sector programs to deal with these problems.

There has been a massive dislocation of American workers in recent years resulting from the interplay of footloose capital, intensified international competition, energy shocks and failed and misguided government economic policies—most notably tight money and its disastrous consequences: sky-high interest rates and an over-valued dollar. The Congressional Budget Office estimates that more than three million persons are victims of economic dislocation. Many of those workers are members of the UAW.

Five years ago, the auto industry and its suppliers provided nearly 3.4 million jobs. In 1982, the total was down to only 2.3 million. This year, despite the fact that all of the Big Three auto companies have moved strongly back to profitability, we estimate that industry employment will be just 2.5 million, 900,000 below the 1978 level.

Sizable job losses also have occurred in other UAW-represented industries, including the agricultural implement manufacturing industry where employment is down more than 50 percent from its level of four years ago.

For years social scientists have been studying the human impact of economic decline and dislocation. Studies have linked unemployment to physical and mental health problems, to infant mortality, suicide and divorce.

For example, the New York State School of Industrial and Labor Relations studied the impact of the Ford Mahwah, New Jersey plant closing on 5,000 UAW members. The researchers found that health, emotional and family problems increased dramatically after the plant shut down. Two-thirds of the workers surveyed reported problems with tension, depression and insomnia. Over half reported that their families were also experiencing emotional or physical health problems. Nearly all of the workers who reported problems felt that those problems had resulted from, or had been made worse by, the closing of their plant and the loss of their jobs.

But studies and statistics alone tell only part of the story about the people who bear the burden of unemployment. We have seen the pain caused to countless thousands of our members as their lives have been shattered and their dreams lost.

Because of the UAW's concern about the availability of re-employment opportunities for our members, and the uncertain economic future that many currently employed members are facing, we have given training and retraining a high priority on our collective bargaining agenda. At the same time that we have been establishing training programs under our negotiated agreements, we have continued our legislative efforts for national policies to generate economic and employment growth, because without such policies, training programs can have little value.

NEGOTIATED JOINT LABOR-MANAGEMENT PROGRAMS

Early in 1982 the UAW established important new training programs with the Ford Motor Company and the General Motors Corporation. The program at Ford is called the UAW-Ford Employment Development and Training Program and the General Motors program, the UAW-General Motors Joint Skill Development and Training Committee.

The focus of both programs is to develop jointly—that is, the Union and management together—programs to provide training, retraining, and developmental opportunities for active and laid-off UAW-represented workers. For laid-off members this includes job-finding assistance. For active members this means assistance to enhance job security and upgrade skills.

Financing for both programs is provided under the collective bargaining agreements at 5 cents per hour worked. This has amounted to approximately $10 million a year going into the UAW-Ford training fund and about $40 million a year into the UAW-GM fund.

Under the UAW-Ford program the first step taken was to establish a jointly directed National Development and Training Center on the campus of Henry Ford Community College in Dearborn, Michigan. The Center plans, designs, and coordinates programs—relying primarily on existing community educational and counseling resources.

The first programs began in the summer of 1982. With Ford's UAW-represented workforce at the time down by 90,000, initial program efforts were aimed at laid-off workers.

The first program implemented was the National Vocational Retraining Assistance Plan—a program of pre-paid tuition assistance which pays tuition costs up to $1,000 a year for qualifying laid-off workers so that they can pursue self-chosen education and training to improve their chances for reemployment within or outside the company.

Tuition assistance in itself is not new at Ford. There has long been a negotiated program that offers tuition assistance to active workers. What is new, however, is that (1) eligible laid-off workers are now receiving such assistance; (2) the plan provides pre-paid tuition in recognition of the fact that laid-off workers are less likely to have "up front" money for tuition; and (3) there is no requirement that education be specifically related to the laid-off worker's former job.

In August of last year, the National Center mailed brochures to 18,000 workers describing the tuition assistance program. The response was enthusiastic. So far, over 2,800 course enrollments have been approved and an average of 100 applications are coming in a week.

Recently the National Center profiled the first 600 workers who have participated in the plan. Over 50 percent chose two-year vocational education degree programs, almost all at community colleges. Of those who chose two-year vocational education programs some 57 percent chose electronics, robotics, or other technology-related course work. Of the 13 percent who selected four-year college and university programs, a third chose business curricula and one-quarter chose engineering or the sciences. These workers tended to select full-time course loads, with the plan paying approximately 95 percent of the average cost of tuition and compulsory fees.

The second UAW-Ford program implemented was the Targeted Vocational Retraining Project, or TVR. Targeted Vocational Retraining is intensive, full-time retraining—generally technical in nature—which will lead to skill certifications in specific occupations.

Projects are established only where there are definite job prospects, and quality educational institutions and vocational training programs are available. Once training is completed, workers receive job placement assistance.

The first two TVR projects were for welding, and tool and die certifications, involving 72 laid-off workers from several Southeastern Michigan plants. Forty-two recently graduated, and close to half already have found new jobs.

Other TVR projects have been initiated at five locations across the country—Sheffield, Alabama; San Jose, California; Nashville, Tennessee; and two metropolitan areas in Michigan—with 300 laid-off workers receiving training ranging from microwave technician to video production technician.

The Career Counseling and Guidance Program was the third early program formulated. It assists both active and laid-off workers to form and reach personal and career goals. So far, six joint local employee development committees have initiated career counseling and guidance for 900 laid-off members in Michigan, Ohio, Minnesota, Tennessee, and Alabama.

Subsequent to these early programs, there have been other activities, including career day conferences, special career plan surveys, job search skills workshops, and special plant closing assistance.

Under the joint UAW-GM program, our initial efforts also concentrated on laid-off workers. In later 1981 and early 1982, the closing of the Fremont and Southgate, California car assembly plants idled some 9,000 workers. Recognizing the high priority for reemployment and retraining for these workers, the Joint Skill Development and Training Committee, in conjunction with the state of California, created a program of skills assessment, job counseling, retraining, and job placement.

Under the program which began last fall and will run through the end of this year, each worker is registered at a reemployment center where a review is made to identify experience, skills, interests, and goals. A determination is made of whether a worker has marketable skills, or is in need of retraining.

At the time of the skills assessment, each worker's personal needs are also assessed, and a variety of personal and family services are offered to help deal with individual problems.

Workers with readily marketable skills and those who develop such skills through retraining are also provided with job search assistance: how to find local job openings, how to secure interviews, and what to expect in the interviewing process. In addition, job referral and placement assistance is provided.

Workers requesting retraining receive a retraining assessment, and individualized retraining plans are developed. Individualized retraining plans involve either developing special training courses or locating openings in existing training programs. Contacts also may be made with employers to establish on-the-job training.

About 1,000 workers are expected to soon complete classroom training and will be joining those already waiting for placement. To meet this need, a marketing plan is being developed to seek out prospective employers and arrange for placements.

The first set of statistics from the project shows that 85 percent of 8,900 eligible workers have registered in the program. Close to one-fifth or 1,300 have found jobs. Approximately 1,800 have received job search training, and 2,100 have been enrolled in training programs.

In addition to the UAW-GM California project, agreement has just been reached to establish a jointly administered development and training center in Flint, Michigan. This center will serve the needs of over 10,000 UAW-represented laid-off workers in the Flint area, as well as the currently employed whose skills may soon become obsolete.

Under the proposed program, workers requesting training will be given an employment assessment and matched against available jobs within the corporation and in the local job market.

Laid-off workers not prepared for direct job placement will be able to chose among self-selected formal education or retraining under a plan of up-front tuition assistance of up to $1,000 a year. Eligible active workers will be placed in inplant training programs.

UAW efforts to negotiate training programs have not been limited to the auto companies. We have also established programs with companies in the agricultural implement industry where our members have also been hard hit by layoffs in recent years.

At International Harvester, for example, in addition to negotiating tuition refund for laid-off workers, the UAW negotiated an outplacement assistance program. Under a special three-year $1 million budget, a variety of job search services are provided, including training in writing resumes, information of job opportunities, as well as information on available support services within the community.

These services have been made available to 12,000 workers idled by plant closings in Kentucky, Indiana, and Illinois. Of the 4,800 who have gone through the program so far, about one-fifth have found jobs.

Early experience with the negotiated programs has been positive. Laid-off members are receiving training and other services which have or will help them regain employment. Programs underway for active members are enhancing their current employability or qualifications for job upgrading.

These programs which have been negotiated by the UAW have an important by-product in that they provide a forum in which to exchange ideas with management on how to develop better and more advanced ways to satisfy our members' training needs. The true potential of these programs will only be reached when dislocation situations are identified ahead of time so that training can be initiated in time to update old skills and develop new ones before the jobs are lost. Workers could then remain on the job or make lateral or upward job moves without having to suffer the trauma of unemployment. The importance of advance notice and adequate lead time cannot be overstated, especially in view of the rapidly changing technology in the nation's plants and offices. In the auto industry alone a ten-fold increase in the robot population is expected between 1982 and 1990, potentially displacing 40,000 workers.

UNION/COMPANY INITIATIVES CANNOT SOLVE THE PROBLEM: FEDERAL ACTION REQUIRED

The UAW intends to build on these accomplishments at the bargaining table but the problem of worker displacement cannot be solved solely through union/company initiatives. While we have been successful in providing training and job search assistance to thouands, hundreds of thousands need such help. Reaching all of the workers who need training requires a strong commitment and decisive action by the federal government.

The federal government also has the responsibility to provide a safety net of social benefits to American workers who lose their jobs, and has the responsibility to implement policies which result in economic growth and full employment.

It is most unfortunate that at a time when the need for federal commitment has been so great, the Reagan Administration has severely cut back federal resources for training activities. Spending for all employment and training activities in fiscal 1983 is expected to total $5.2 billion, $300 million less than in 1982 and $4 billion less than in 1981—before taking inflation into account. The President's 1984 budget proposal would cut employment and training outlays even further, by proposing that only $4.7 billion be spent, 8 percent less than in fiscal 1983.

Those in need of public employment and training assistance will have to rely on a reduced federal program—the Job Training Partnership Act (JTPA). JTPA, which replaces the Comprehensive Employment and Training Act (CETA), is seriously inadequate in a number of respects. It does not, among other things, provide for public service employment.

DISLOCATED WORKER PROGRAM UNDER JTPA

One positive aspect of JTPA is that it establishes a dislocated worker program. The UAW is gratified that Congress provided some funding, though at a minimal level, for the dislocated worker program in the present fiscal year.

In states where sizable numbers of our laid-off members live we are actively pursuing opportunities under JTPA. In Ohio, for example, through the efforts of our National Aerospace Department and Ohio regional offices, the UAW has received a grant from the state's JTPA dislocated worker fund to work jointly with Rockwell International Corporation and other aerospace employers to design a program which will match displaced auto workers with emerging aerospace jobs.

A grant has been secured jointly by the State of Alabama, UAW local leadership in Sheffield, and the UAW-Ford National Training Center to provide instruction in robotics maintenance, computer-aided drafting and computer programing for 650 UAW members who lost their jobs when Ford Motor closed its Sheffield, Alabama die casting plant in July.

The UAW Job Development and Training Department has continued programs carried over from the CETA program during the JTPA transition phase—including those targeted toward displaced workers from auto and other industries. These are well established and extremely successful programs and we hope to be able to continue them under JTPA. The UAW also has submitted proposals to establish job clubs to re-teach job search skills to dislocated workers in Michigan, New York, and Alabama.

INADEQUACIES OF THE JTPA PROGRAM

The JTPA dislocated worker program, however, is not large enough to meet existing need. With the funds available in this fiscal year, fewer than 40,000 workers will be served and the Administration's funding proposal for next year would enable only 96,000 workers to receive assistance. Moreover, it is uncertain that the available funds will be able to provide even these few workers with the full complement of services that are necessary to enhance their ability to regain employment. At the very least, this program should be funded at $2 billion in the upcoming fiscal yea

One of the most important elements missing from the dislocated worker program is the requirement that a company give advance notice when it closes a plant or lays off a portion of its workforce, such as would be required under H.R. 2847, the National Employment Priorities Act, which we support. When sufficient advance notice is given there is time to develop and implement a plan to help workers obtain the necessary training and line up new jobs before the plant closes or the layoff takes effect.

The present structure of the dislocated worker program also has serious limitations which hamper the effectiveness with which even the program's limited funds can be utilized. Restrictions on stipends and allowances prevent many workers from participating in training programs because they lack the financial resources to support themselves and their families while in training. Limited availability of stipends and allowances also tilt training programs in the direction of short-term training, which often fails to develop the skills necessary to qualify for good long-term jobs.

Under the current program, supportive services are forced to compete for a small pool of potential funding. These support services can be of crucial importance. Often the availability of crisis intervention and counseling services, such as family and credit counseling, are a pre-condition for success of training or other forms of assistance. Many dislocated workers, particularly those who have been unemployed for some length of time, cannot pay for transportation to the training site, and do not have money for lunches, telephone calls for job search activities, and transportation for job interviews. In some cases, single parents are unable to participate in training programs without child care.

Limitations on stipends, allowances, and supportive services should be removed, and the program should be expanded into the areas of health care protection and assistance with mortgage payment difficulties.

The program also would be more effective if more opportunities for meaningful input from labor unions were available. The law presently recognizes the important role that labor plays in developing programs to assist dislocated workers by providing that programs to assist union members will be established after full consultation with their labor unions. Because of their vast experience with assisting workers and helping to resolve worker problems, labor unions are in a unique position to render meaningful and effective counsel regarding training and training-related programs.

Our early experience with state Job Training Coordinating Councils (JTCC) indicates a real need to ensure an active role for these councils. Members of these councils represent a broad constituency within the community, including labor, and can provide important input and valuable resources for meeting the employment and training needs of dislocated workers within the states. It should be required that state JTCCs review and comment on all dislocated worker programs before decisions are made on which projects will be funded.

The federal government also has a far more important role to play than that which it has been assigned by the current legislation. Congress may have intended that the states have flexibility in the design and administration of programs, but this should not preclude the federal government from providing guidance to ensure that programs operate effectively and equitably and achieve common goals. Indeed, Congress clearly expected the federal government to set minimum guidelines to ensure that the objectives of JTPA are met and a cohesive program develops.

One area where the federal government is expected to take responsibility is in setting performance measures. Without a national system of reporting and performance standards, it cannot be determined which training approaches work best and which fail to justify continued funding. Nor will it be possible to use the JTPA experience to assess the broader policy implications of employment and training programs—so judgments can be made on future policy directions. In the development of a national system of performance standards, it is important to recognize that standards be designed to be sensitive to, and realistic about, the economic conditions within individual states. In recognition of the importance of national reporting, the Department of Labor has just issued regulations on reporting requirements and performance standards. Unfortunately, these regulations fall far short of meeting their objective. No followup information on workers who have participated in the dislocated worker program is required, limiting the ability to properly assess JTPA-funded programs.

Effective federal leadership also has been lacking in the implementation timetable under the dislocated worker program. States have been behind the initial schedules set for them, and have been slow to obligate their dislocated worker funds. Federal leadership is needed to ensure that states act promptly to put in place dislocated worker programs.

Not only should Congress act to correct these inadequacies, it should develop ways of handling dislocation which demonstrate a real government commitment to help workers. We would suggest looking at the experience of other industrialized countries in designing employment and training programs, particularly with regard to displaced workers.

In Canada, for example, advance notice of plant closings is required by provincial law. This requirement provides companies and unions time in which they can call upon Canada's Manpower Consultative Service for help. In an advisory capacity the Service assists the parties to devise and operate a plan to place workers in other jobs before the gates close. When necessary, the Service helps workers move to where jobs are, retrains them, offers them job search assistance, and supplies major benefits such as health insurance during the transition period.

Western European countries and Japan also handle plant closings and permanent layoffs in ways that are far in advance of the U.S. in their concern for the affected workers and communities.

In Germany, advance warning is required of plant closings. Before a plant can close, the company and its works council must draw up and agree on a "social plan" that spells out a course of action for each affected worker. For some workers this may involve direct placement in other jobs. For others it may involve retraining or relocation. Although readjustment assistance usually is a company responsibility, government subsidies are available.

In Sweden, advance notice of a shutdown is also required by law. A Regional Labor Market Board takes primary responsibility for helping workers regain employment. Immediately after the company announces the expected closing, the board establishes job-finding centers at the closing facility which tie into a nationwide computerized job vacancy identification system. Companies are required to list all vacancies with the National Labor Market Board, and federal funds are available for relocation assistance and retraining.

The focus of the dislocated worker program—and all training programs—is training. However, no amount of training and job-search assistance will help if jobs do not exist. The fundamental requirement for the success of training programs is employment growth.

CONCLUSION

To assure steady economic growth and full employment, we need a coherent full employment macro policy, coupled with an industrial policy which includes a system of national planning to manage our resources in a manner that best serves the country's needs. Training programs should be an important component of that policy, as should the regulation of plant closings and provision of a guaranteed social safety net for dislocated workers.

The UAW will continue its efforts through collective bargaining to provide its members with training, retraining, and job upgrading opportunities. At the same time, we will continue and redouble our political efforts on behalf of sound national policies that will create the jobs for graduates of training programs to find.

Mrs. KENNELLY. Thank you very much, Mr. Friedman.

Dr. Drew.

STATEMENT OF RUSSELL C. DREW, CHAIRMAN OF THE GOVERNMENT ACTIVITIES COUNCIL OF THE UNITED STATES ACTIVITIES BOARD, INSTITUTE OF ELECTRICAL & ELECTRONICS ENGINEERS, INC.

Mr. DREW. Madam Chairman, I am here today to testify on behalf of the IEEE; that is, the Institute of Electrical & Electronics Engineers.

The IEEE is the world's largest technical professional society with over 230,000 members worldwide and over 190,000 members in the United States. Our membership is at the leading or cutting edge of advanced technology throughout industry and society as a whole, and it represents a very important part of the human capital of the United States in dealing with the technological race that we are in with respect to other industrialized countries throughout the world.

The IEEE has long stood for a high quality educational background and the need for continuing attention to upgrade that educational background throughout the work lifetime of its members.

Increasingly, however, we find that the pace at which technology has been changing is accelerating, and it is affecting the ability of the individual members to maintain their currency. So we are taking every possible step that we can to improve the environment and the climate for the technological members of society, in this case from the IEEE, to maintain and increase their capability to deal with this changing technological picture.

We believe it is absolutely essential for the provisions of H.R. 2568 to be implemented because of its non-job-related aspect. The premise that one can be supported for direct job-related training is, of course, well understandable and is a tradition which we would certainly support. But because of the way the technology is changing, it is becoming terribly important to begin to move out ahead of these direct job-related responsibilities, because the nature of that job is going to be changing rapidly.

The ability of our industry to be able to respond to these technological challenges, to be able to introduce the new products and services that are going to keep us economically competitive will depend very strongly on this human capital—the human capital represented by the technicians, the workers, the engineers in industry and throughout society. So we very strongly support the provisions of this bill.

We encourage that it be put on a permanent basis. In fact, we see the requirement for additional incentives in providing a lifelong education for individuals involved in high technology in the United States.

This concludes my summary statement. I have a statement which you have indicated will be put in the record.

Thank you very much.

[The prepared statement follows:]

STATEMENT OF DR. RUSSELL C. DREW, CHAIRMAN OF THE GOVERNMENT ACTIVITIES COUNCIL OF THE UNITED STATES ACTIVITIES BOARD OF THE INSTITUTE OF ELECTRICAL & ELECTRONICS ENGINEERS, INC.

Mr. Chairman, it is indeed a pleasure to have this opportunity to present the views of the Educational Activities Board of the Institute of Electrical and Electronic Engineers, Inc. on H.R. 2568, a bill to amend the Internal Revenue Code of 1954 to repeal the provision which terminates the exclusion for amounts received under certain educational assistance programs.

My name is Russell C. Drew. I am the chairman of the Government Activities Council of the IEEE's United States Activities Board. The IEEE was founded in 1884, and it is the largest technical professional society in the world, with over 190,000 members in the United States, and more than 230,000 members world-wide.

One of the principal missions of the IEEE, as stated in the Constitution, is scientific and educational activity, "directed toward the advancement of the theory and practice of electrical engineering, electronics, radio and the allied branches of engineering." The educational activities are primarily carried out through the Educational Activities Board, which is responsible for policy recommendations on educational matters and for the broad planning of the Institute's educational activities, including continuing education. For matters which pertain specifically to the U.S., the Institute has constituted the United States Activities Board, of which I am a member. I am here today particularly on behalf of the Educational Activities Board to seek the subcommittee's help in enactment of legislation that will maintain a tax exemption for employer-paid continuing education tuition aid.

The Employee Educational Assistance Extension section of the Revenue Act of 1978 (P.L. 95-60), allows employees to receive training and education courses for upgrading skills and learning new job responsibilities as part of an employer's tuition assistance program. When employees are reimbursed for the training and education (typically in-house, or at a community college or university), the employees are not taxed on that reimbursement as income.

Given the constantly changing employment picture in the country, it seems appropriate for the Federal government to adopt tax policies that encourage employees to obtain retraining and advanced knowledge and skills through employer-provided educational assistance. And at a time when we have a critical need to develop the quality of the work force and improve national productivity, we should not deliberately restrain an efficient technique for improving human capital.

The present rapid rate of scientific and technical innovation has given new emphasis to the need for engineers and technicians to enhance and renew their technical competence on a continual basis.

The individual engineer has a personal responsibility to plan and develop a program for life-long learning that will assure his or her continued technical renewal. Each year, the technical competence of the engineer must be expanded so that he or she is prepared to undertake, next year, tasks for which the background was not available last year.

Similarly, the employer has a responsibility to encourage and assist the engineer in improving technical competence. Challenging job assignments must be provided; time and opportunities for formal courses must be made part of the working environment; recognition must be provided to those engineers who do enhance their technical competence and, thus, increase their ability to contribute to the performance and profitability of the employer.

Unless appropriate steps are taken continually to enhance technical competence, every engineer faces the threat of technical obsolescence. Life-long learning—in the broad sense—must be pursued if technical obsolescence and its undesirable consequences are to be avoided.

Engineers and technicians are a national asset and their competence needs continual renewal. The urgency of need is greater than ever before because the technology is changing very rapidly in the areas of interest to the IEEE, such as computers, Very Large Scale Integration (VLSI), and advanced electronics systems.

IEEE is involved in efforts to encourage engineers and technicians to plan life-long learning activities as a part of a productive career and to encourage employers to support this effort. It is to their mutual advantage to do so. An important aspect of our competitive posture in the face of increasing international competition is the availability of a trained and effective technical work force.

The change from a non-taxed situation to a situation in which the individual is taxed for employer-provided tuition aid would discourage adoption of life-long learning as part of the career development of engineers and other technical workers. This would counter efforts of IEEE and other engineering societies in urging employees and employers to plan for life-long learning.

The IEEE Educational Activities Board at its August 10, 1983, meeting urged the support and passage of H.R. 2568. This is an important step to maintain an incentive for our high technology work force to upgrade its skills and keep pace with the increasing demands of the marketplace.

This ends my prepared statement Mr. Chairman. I would be pleased to answer any questions.

Mrs. KENNELLY. Certainly it will be put in the record.

Thank you, Dr. Drew.

Mr. Crotty.

STATEMENT OF M. PATRICK CROTTY, VICE PRESIDENT-INDUSTRIAL RELATIONS, ROCKWELL INTERNATIONAL CORP., ACCOMPANIED BY RAYMOND GARCIA, DIRECTOR, LEGISLATIVE AFFAIRS

Mr. CROTTY. Thank you.

Madam Chairman, thank you for the opportunity to be here and to discuss Rockwell's and the American Society of Training Directors' views relative to H.R. 2568. I am here to testify for both of them. And although I cannot say I represent industry as a whole, I can assure you that I do know as a matter of fact that about 90 percent of the companies in this country do have these tuition reimbursement educational assistance programs, and they are very important to us.

Rockwell is a company with about 100,000 employees. It applies high technology to automotive, aerospace, electronics, and industrial products. The American Society for Training and Development has 500,000 members throughout the country, it has 138 chapters, and it provides very specific and quality assistance in training, education, and all types of human resource development.

In the interest of brevity I will not read my statement into the record. It is made a part of the record, and I ask you to accept it, Madam Chairman, as my testimony.

Mrs. KENNELLY. That will be done.

Mr. CROTTY. However, I would like to emphasize a few points, if I may.

I would like to say my being brief does not in any way diminish the importance that we at Rockwell and the American Society for Training and Development put on this piece of legislation. It is very serious. It is very important to our businesses. It is very important to the country, and we urge your support of continuing excluding these moneys from the income tax of individual employees.

At Rockwell in the L.A. basin we have 45,000 employees. About 10 to 12 percent of them participate in these programs. Sixty percent of them are taking technical and engineering courses. Thirty percent of them are women. Twenty percent of them are minorities.

Now, we spend about \$2¾ million on this annually just in the L.A. basin. We have noticed in the last 2 or 3 years an accelerated pickup in the number of people participating in these programs. In fact, the rate went up from 1982 to 1983 by about 16 percent.

Now, the point here is that we at Rockwell will continue these programs, and I feel very confident in saying the majority of the companies will continue them no matter what we do here.

The important thing, as we see it, is that if we include these in the income tax provisions, we will provide a pall and a chill on the participation of employees in these programs. And I think that would be virtually disastrous to do that. We feel very strongly about that.

Needless to say, the points that were made here about the fact that we have got to get with competition, that we have a big problem relative to the rapid turnover and development of state of the art in technologies, and employees have to keep up—all of those things would be hurt.

Now, I want to make just one other point, and that is this point of the problem of the administrative burden that reverting to the pre-1978 regulations would impose upon us in industry. For example, the American Society for Training and Development made a survey of the companies and how they handled these tax deductions. Forty-one percent of them withheld on every reimbursement activity on all of them. In other words, no matter whether they qualified under the regulations or not, they were all paying taxes. Forty percent of the companies did not withhold anything. Twelve percent of them tried to make judgments as to whether they should withhold or whether they should not.

So you have a very, very messy situation then. Some people were paying when they should not. Others are not paying when they should.

I would like to make one other comment and stress another point relative to collective bargaining. And my associate here, Sheldon, and us and the company had an experience when we were going through the downturn in the automotive industry and the concurrent buildup in the aerospace industry at Rockwell. In the particular UAW unit we were dealing with in automotive we had 6,500 people. When the aerospace industry was down, we had 4,000 people. The hard times came upon the automotive industry, and that went from 6,500 down to 1,500. At the same time we were building up in the aerospace industry, so we were able to sit down with the UAW and work a program where we would train and transfer these people from the automotive industry into aerospace.

Now, it is not any great shakes yet. It is working, and we are in fact retraining and bringing these people across. And would it not be a shame if we now penalized them and increased their cost for upgrading their own skills and abilities.

So with that word, then, I would like to urge upon you to be restrictive and do not apply these moneys into the income tax of our people.

Thank you very much.

[The prepared statement follows:]

STATEMENT OF M. PATRICK CROTTY, VICE PRESIDENT-INDUSTRIAL RELATIONS, ROCKWELL INTERNATIONAL CORP.

Good afternoon, Mr. Chairman and Members of the Subcommittee. My name is Patrick Crotty. I am Vice President-Industrial Relations of Rockwell International Corporation. I am testifying on behalf of my company and the American Society for Training and Development (ASTD), of which Rockwell International is a member.

Rockwell International Corporation is a major multi-industry company. It employs nearly 100,000 people, applying advanced technology to a wide range of products in its automotive, aerospace, electronics and general industries businesses. The ASTD comprises 50,000 members in 138 chapters throughout the United States, who primarily administer employer-employee educational assistance programs.

We are pleased to appear before you today in support of H.R. 2568, legislation designed to retain current tax rules leaving employer-paid tuition aid tax exempt.

The Congress found many sound reasons in 1978 to pass legislation that excludes from taxable income the tuition that an employer pays to cover the career education of his employees. It recognized the need for investments in human resources to assure a skilled work force that can meet the demands of an increasingly competitive global marketplace. It recognized the advantages of providing greater access to education and economic opportunity to those who have had limited access to it, particularly women and minorities. And it recognized the value of assisting the growing number of workers whose jobs are permanently being eliminated as the structure of the world economy undergoes massive change.

It is estimated that there are between three-and-a-half and four million of these structurally unemployed workers in the United States now, and that their number will grow to 10 to 15 million in the next two decades. That means that there is an enormous need for worker retraining. And employer educational reimbursement can contribute importantly to seeing that that need is accommodated.

For a high technology company, such as Rockwell, continued education of our employees is an indispensable means of avoiding technological obsolescence. One out of every six Rockwell employees is either a scientist or engineer. As ever greater technological and scientific advances are made, their task to stay abreast of these developments becomes ever more difficult. Continued education for them is a must not a luxury.

At our west coast operations about 10 percent of our 45,000 employees now participate in employer-reimbursed education, costing $2.75 million in 1983. This is 16 percent greater than in 1982. At our Defense Electronics Operations in Anaheim alone, there are 415 employees taking 1,363 courses involving 52,691 student hours. Sixty percent of the courses being taken are in science and technology disciplines. Twenty-eight percent of the students are female and twenty-one percent are minorities.

We believe that the Employee Educational Assistance Extension Act offers substantial encouragement to our employees to continue their education and to upgrade their skills. Skill renewal and job training will become even more crucial in years to come as world competition intensifies and the work force becomes increasingly technological. More and more labor-management contracts recognize these developments and place greater emphasis on job training and retraining benefits.

Tax exempt employer-paid tuition aid has proven its worth to management and labor alike.

It has helped companies assure the availability of highly skilled, well educated professionals for key technical positions.

It has permitted workers to keep pace with changing skill demands.

It has allowed women and minorities to enter new and higher-paying jobs.

H.R. 2568 extends these benefits beyond December 31, 1983. That is why Rockwell supports this legislation and urges Congress to enact it.

I would be pleased to respond to your questions.

Mrs. KENNELLY. Thank you very much, Mr. Crotty, for your excellent testimony.

Dr. Niederhauser.

STATEMENT OF WARREN D. NIEDERHAUSER, PRESIDENT-ELECT, *AMERICAN CHEMICAL SOCIETY*

Mr. NIEDERHAUSER. I am here to present the views of the American Chemical Society, a nonprofit scientific and educational organization with a membership of 126,000 chemists and chemical engineers.

These comments have been approved by our board of directors. We are particularly pleased to see the subcommittee hold these hearings. We supported the enactment of section 127 back in 1978, and we support its extension now.

The reasons we need section 127 have not changed. In fact, they have grown stronger. Section 127 removes the job-related distinction in the tax treatment of educational assistance. It makes clear educational assistance is excluded from an employee's gross income. It provides an incentive for employees to upgrade and improve their skills and for employers to provide educational assistance.

There are many reasons for supporting this tax incentive. First, the knowledge explosion in recent years has been phenomenal, particularly for scientists and engineers who must continue their education to keep up with their fields and improve their knowledge, inventiveness, and creativity.

Within science and engineering, many disciplines such as the chemistry of life processes, biotechnology, new types of analytical chemistry, and the use of computers are advancing very rapidly. The costs of not keeping up with the latest developments here are very high, not only in terms of individual losses of career opportunities, but also in society, societal costs.

The costs to our country include loss of productivity, reduced innovation, and a decline in the scientific and technical strength of the Nation. In academic institutions the problem is compounded. Students, our future inventors and scientists, are inadequately prepared because their teachers have become obsolete. Continuing education courses help scientists get training in related fields.

In our own discipline of chemistry, the National Science Foundation found that graduates of the year 1978 with bachelor's degrees in chemistry who were employed in 1980, some 5,600 persons, 2 years out of school, only 48 percent were employed in chemistry. Close to 31 percent were employed in the related fields of science and engineering, and 21 percent outside those fields.

These figures shows that many of these chemists receive continuing education to qualify them for jobs outside but related to their initial training. As our society becomes more technological, we need people with science or engineering expertise who go on to receive training in nonscientific fields. This dual background will equip people to deal with the many decisions surrounding the management and control of science and technology.

Twenty-one percent of scientists and engineers working in 1980 were involved in managerial or administrative duties. Two-fifths of these, in turn, managed research and development programs. Scientists and engineers with these responsibilities should be able to take advantage of employer-related educational assistance to study business management, accounting, and similar fields if our country is to remain competitive.

Data available from the National Science Foundation point to the importance of continuing education for scientists and engineers. In the 1975 to 1976 academic year over 30,000 scientists and engineers enrolled in degree credit courses offering an average of 3 hours' credit. In addition, almost 187,000 scientists and engineers enrolled in noncredit continuing education courses.

In 1978 a survey of scientists and engineers conducted by the Bureau of Census for the National Science Foundation showed that 40 percent of employed chemists received some form of training each year.

Another point to consider is that educational assistance programs help employees prepare for higher level jobs. This is important in the case of those who have been educationally disadvantaged.

Educational assistance programs promote equal opportunity. We believe that programs promoting this fundamental American value should not be taxed—another reason for encouraging assistance. Such programs upgrade the skill level of the work force as a whole. As we approach the 21st century, a highly trained, technically competent work force will become more and more essential. According to a 1982 report by the National Science Foundation, between 1970 and 1980 about 90 percent of the growth in scientific and engineering employment was linked to an increase in overall economic activity. We believe this is a cause and effect.

This trend will almost certainly continue, if not accelerate. Educational assistance programs provided by employers will help meet the need for a more scientifically competent work force. In the long run, such programs can reduce unemployment by allowing workers with obsolete skills to be retrained for new jobs. It will also help our Government workers who are on boom and bust programs, such as in space and energy—it will help keep them up to date and employable.

Over the last year we have seen a renewed public interest in educational quality, especially in mathematics and sciences. Quality in math and science education is vital to our long-term national interest. It is inconsistent for our Government to spend large sums of money to support the science and math education, on the one hand, while taxing educational assistance programs on the other.

The American Chemical Society believes this inconsistency can and should be created by making tax policy agree with the goals of improving the quality of education in the United States.

For all of these reasons we hope that the exclusion from gross income of employer-provided educational assistance will be made permanent.

Thank you for the opportunity to testify.

[The prepared statement follows:]

STATEMENT OF DR. WARREN D. NIEDERHAUSER, PRESIDENT-ELECT, AMERICAN CHEMICAL SOCIETY

Mr. Chairman and members of the Subcommittee, my name is Warren D. Niederhauser. I am here to present the views of the American Chemical Society, a nonprofit scientific and educational organization with a membership of over 126,000 chemists and chemical engineers. These comments have been approved by our Board of Directors.

Mr. Chairman, the American Chemical Society is very pleased to see the Subcommittee hold these hearings on the extension of section 127 of the Internal Revenue Code. This section, which was enacted in 1978, clarifies the tax treatment of educational assistance provided by employers to their employees. It states that the amount of such assistance is excluded from the employee's gross income.

We note that the package of tax reforms approved last month by the Committee on Ways and Means exempts from taxation certain tuition reductions for employees of educational institutions and members of their immediate families. Implicit in this action is the Committee's recognition that educational assistance is different from many other fringe benefits. We urge the Committee to take a step further in this recognition by extending section 127 of the Internal Revenue Code which expires at the end of this year.

The American Chemical Society supported the enactment of section 127 in 1978, and we support its extension now. The reasons why section 127 is needed have not changed.

Before section 127 was enacted, IRS regulations put the burden upon the employer to determine whether a course of study taken by an employee maintained or improved the skills required for the employee's present position. If the course did not meet this test, the employer had to withhold taxes on the amount paid for the course, and this amount had to be included in the employee's gross income. The line between educational assistance which had to be included in gross income, and educational assistance which could be excluded was rather blurred. This caused each employer to interpret the rule differently. To be on the safe side, some employers used an unnecessarilly strict definition of what was a "job-related" course.

Section 127 removes the "job-related" distinction in the tax treatment of educational assistance. It makes clear that educational assistance is excluded from an employee's gross income. This section, therefore, provides an incentive for employees to update and improve their skills, and for employers to provide educational assistance. There are many reasons for supporting this tax incentive.

First, the knowledge explosion since World War II has been phenomenal, particularly in science and engineering. It is necessary for scientists and engineers to take continuing education courses to keep current in their fields. Keeping current enhances their knowledge, inventiveness, and creativity. Within science and engineering, certain disciplines—such as the chemistry of life processes—are advancing even faster than others.

The costs of not keeping abreast of the latest developments in science and technology are high—not only in terms of individual losses of career opportunities, but in societal costs as well. Societal costs include: loss of productivity, reduced technological innovation, and a general decline in the scientific and technical strength of the nation. In academic institutions, the problem is compounded if students—our future workforce—are inadequately prepared because what teachers know may have become obsolete.

Continuing education courses aid in the development of scientists in other ways. For example, they help scientists obtain training in a closely related field. In our own discipline of chemistry, the National Science Foundation[1] found that of the graduates of the year 1978 with bachelor's degrees in chemistry who were employed in 1980—some 5,600 persons—48 percent were employed in chemistry. Close to 31 percent were employed in other fields of science and engineering; and 21 percent were employed outside those fields. One can infer from these figures that at least some of these chemists received some form of continuing education that qualified them for jobs outside their field of initial training.

As our society becomes increasingly more technological, we will need people with science or engineering expertise who go on to receive training in non-scientific fields. This dual background will equip people particularly well to deal with the many decisions surrounding the use, management, and control of science and technology.

For example, 21 percent of scientists and engineers employed in 1980 were involved in managerial or administrative duties as the major part of their job responsibilities. Two-fifths of these in turn managed research and development programs. Scientists and engineers with these responsibilities should be able to take advantage of employer-provided educational assistance to study business management, accounting, and other similar fields.

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[1] "National Patterns of Science and Technology Resources 1982." National Science Foundation. 1982. p. 80.

The most recent data available from the National Science Foundation point to the importance of continuing education for scientists and engineers. In the 1975–76 academic year, over 30,000 scientists and engineers enrolled in degree credit courses offering an average of three hours credit. In addition, almost 187,000 scientists and engineers enrolled in non-credit continuing education courses.[2]

In chemistry, the 1978 National Survey of Natural and Social Scientists and Engineers conducted by the Bureau of Census for the National Science Foundation showed that 40 percent of the employed chemists received some form of training each year.[3]

Another point to consider is that educational assistance programs help entry-level employees in their careers by preparing them for higher-level jobs. This is particularly important in the case of those employees who have been educationally disadvantaged or deprived. In short, educational assistance programs promote equal opportunity. We believe that programs promoting this fundamental American value should not be taxed.

Another reason for encouraging educational assistance programs is that, over time, such programs upgrade the skill level of the workforce as a whole. As we approach the 21st century, a highly trained, technically competent workforce will become more and more essential. According to a 1982 report by the National Science Foundation, between 1970 and 1980 about 90 percent of the growth in scientific and engineering employment was linked to an increase in overall economic activity. This trend will almost certainly continue, if not accelerate. Educational assistance programs provided by employers will help meet the need for a more scientifically competent workforce. In the long run, such programs can reduce unemployment by allowing workers with obsolete skills to be retrained for new jobs.

Over the last year, we have seen a renewed public interest in educational quality, especially in mathematics and the sciences. Quality in science and math education is vital to our long-term national interests. Given this situation, it is inconsistent for our government to spend large sums of money to support science and math education on the one hand, while taxing educational assistance programs on the other. The American Chemical Society believes that this inconsistency can and should be corrected by making tax policy agree with the goals of improving the quality of education in the U.S.

Finally, according to a recent report prepared by the staff of the Joint Committee on Taxation, revenues the federal government can expect to raise by taxing employee educational assistance programs would be less than $50 million per year. The revenues accruing to the government from the elimination of section 127 would in fact be even lower, since "job-related" courses of study would still be exempt from taxation. Thus, the benefits that section 127 promises to bring are great compared to its minor cost to the Treasury.

For all of these reasons, we hope that the exclusion from gross income of employer-provided educational assistance will be made permanent. Thank you for the opportunity to testify on this important issue, Mr. Chairman, and I will be happy to answer any questions that you might have.

Mrs. KENNELLY. Thank you very much, Dr. Niederhauser.

I wonder if any of you have any figures or statistics on how a program like this would benefit minorities and women. Do any of you have any figures, any breakdown between men and women, or do you keep your figures as aggregates?

Mr. CROTTY. I indicated in the basin 45,000 people with about 40,000 participants, about 30 percent of them are women. Does that help, Madam Chairman?

Mrs. KENNELLY. Yes. It is positive.

Mr. Friedman.

Mr. FRIEDMAN. I might add to that. In the auto industry the work force is about 22 percent black and other minorities, which is roughly double the national average percentage of labor force of those groups. So among the unemployed autoworkers who are eligible for the Ford and GM programs I mentioned, a very high percentage will be minority workers.

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[2] "Science and Engineering Education: Data and Information." Office of Scientific and Engineering Personnel and Education, National Science Foundation. 1982. pp. 80–81.

[3] Unpublished data. National Science Foundation.

Mrs. **Kennelly**. Thank you, Mr. Friedman.

Mr. **Crotty**. Madam Chairman, I want to add just one point. If, in fact, we revert to the 1978 regulations, I think it will have a tendency to ghettoize women and minorities in the jobs they are in, because, you see, it does not allow them to get out and get the courses they need to move from those jobs.

We think that is a very important piece of it. It will not allow them to grow.

Mrs. **Kennelly**. Thank you, Mr. Crotty.

I see we have a recorded vote, and so I think we will take a slight recess until 4:05.

And, Mr. Friedman, I would like to congratulate you on your victory today.

Mr. **Friedman**. That is the first I had heard of it. Thank you. It is good news indeed.

Mrs. **Kennelly**. We will be back at 5 minutes after 4.

[Recess.]

Chairman **Stark**. The committee will resume, and our first witness will be——

Mrs. **Kennelly**. The gentleman in the blue tie. No, it is not. [Laughter.]

Mr. **Gibbons**. I have on a red tie today.

Chairman **Stark**. I understand that one of the witnesses on our panel has a plane to catch. I am sure Mr. Gibbons would be willing to testify and let the panel assemble around him in a show of support.

And, Sam, your prepared remarks will be included in the record in their entirety if you would like to summarize.

STATEMENT OF HON. SAM M. GIBBONS, A REPRESENTATIVE IN CONGRESS FROM THE STATE OF FLORIDA

Mr. **Gibbons**. I think the first thing I ought to do is explain what a terminal rental adjustment is.

Chairman **Stark**. If you would share with us, Mr. Gibbons, your feelings about H.R. 4135, which would limit the tax breaks that owners of luxury cars can get in a trade or business to $15,000 per car. In addition the committee would be interested in your comments on expanding these leasing provisions to other types of equipment which we will consider concurrently with this bill.

Mr. **Gibbons**. I drive a 1968 Chevrolet station wagon, Mr. Chairman.

Chairman **Stark**. That is probably worth $25,000. [Laughter.]

Mr. **Gibbons**. I am here today to talk about H.R. 1607, which is my bill to correct the TRAC, or terminal rental adjustment clause.

For about 30 years everyone involved in the leasing of automobiles considered the terminal rental adjustment clause as being a proper insertion in lease contracts. The IRS thought so, the courts thought so, and certainly the people in the business thought so.

The American automobile manufacturers support this. The labor unions support this. And certainly I support it. But the terminal rental adjustment clause is a good, sound economic idea. I think all of us know, having had any experience with cars, if you treat them right, the trade-in value is a heck of a lot better. The resale value, the salvage value, whatever it is, is a lot better. If you beat them all up, it is not good economy for the individuals involved, and it is not good economy for the Nation.

So as an economic tool to try to encourage people to do the right thing by a car, which is a sensitive piece of machinery, a terminal rental adjustment charge was put in. It simply means that if you have taken good care of the car while you have it leased, you get a little refund on your rent or your lease. If you beat it all up, you suffer the penalty.

As I say, for 30 years this was the law. Suddenly, the IRS by regulation started changing it. Last year in TEFRA we, I think with no dissent on this side, told the IRS that is not the proper law, the one you are trying to make by regulation, outlawing these terminal rental adjustment charges. And, two, if you are going to do it, have a hearing, make a decision, change it on all leases.

Well, the IRS kind of waved at us as we went by. Shortly after the Congress adjourned they started changing the law again back to what they thought it ought to be and not what Congress thought it ought to be. So I came back again and asked the Congress again to instruct the IRS as to what we think the law is and asking them to obey it.

That is essentially all my bill does, Mr. Chairman.

I will be glad to answer any questions you have. I have a formal statement, and of course, it is all a part of the record.

I have capsulized this a great deal, but I realize you do not want a lot of talk.

By the way, I almost forgot to say, and this is important, this bill over a 5-year period, according to the Joint Committee, this bill makes money for the Government, and there are not many of them.

[The prepared statement follows:]

STATEMENT OF HON. SAM M. GIBBONS, A REPRESENTATIVE IN CONGRESS FROM THE STATE OF FLORIDA

Mr. Chairman and members of the Subcommittee, enactment of H.R. 1607, a bill to amend the Internal Revenue Code of 1954, to make it clear that certain motor vehicle operating leases are leases, is needed to deal with the IRS' hasty publication in November of 1982 of a proposed regulation that would prevent openend motor vehicle TRAC leases from being respected as leases for Federal income tax purposes. The regulation would have exactly the opposite effect of TEFRA section 210, which by statute provided the basic rule that the fact that a qualified motor vehicle operating agreement contains a terminal rental adjustment clause (TRAC) shall not be taken into account in determining whether such agreement is a lease. The regulation was publiched without any of the tax policy or economic or revenue impact studies contemplated by Congressional sponsors of TEFRA section 210.

My bill, H.R. 1607, like H.R. 3857 which I introduced in the 97th Congress early in 1981, would prevent the IRS from effecting such a drastic change in policy without the involvement of Congress through further legislation.

H.R. 1607 provides the same rules as provided by section 210 of TEFRA (attached), except for two modifications:

(1) The general rule provided by the bill can be terminated or modified only by Congress.

(2) The general rule is extended to property leased for personal use.

As to the first change, the bill would settle a controversy that many Members thought should never have arisen and that was thought to have been settled by section 210 of TEFRA. Section 210 permitted the general rule to be terminated either by further act of Congress or by the publication of a regulation providing that any agreement with a TRAC clause is not a lease. However, the legislative history makes clear that Congressional sponsors of section 210 expected this regulatory power to be exercised only under extraordinary circumstances and then only after completion of tax policy and economic impact studies. It is clear to me and other Members of Congres, and I think it should have been clear to the Treasury Department, that Congress would not enact the general rule of law provided by section 210 and intend that that rule of law could be replaced pursuant to a delegation of legislative authority with exactly the opposite rule under an "interpretative" regulation. No regulation could satisfy the requirements of section 210 unless it explicitly stated a rule of law providing "that any agreement with a terminal rental adjustment clause is not a lease."

The second change that I mentioned that H.R. 1607 would make in section 210 is to extend the general rule to property leased for personal use. Earlier this year the IRS issued Revenue Ruling 83-109 (I.R.B 1983-32,05) holding that an automobile that is leased to an individual who uses it for non-business purposes is section 38 property to the lessor for investment tax credit purposes. The principles of this ruling should (if it doesn't already) apply equally to leases with TRAC clauses.

The bill may be said to be revenue-neutral, although it is estimated that for the five fiscal years 1984-1988 it would produce aggregate net revenues of $91 million.

This proposal is supported by a coalition of the major motor vehicle manufacturers (General Motors, Ford Motor Company, and Chrysler Corp.), labor (UAW), automobile dealers (NADA), and vehicle lessors.

As evidenced by Joint Committee staff estimates of an actual revenue gain from enactment of H.R. 1607, the transactions that are the subject of this proposal are clearly not "tax shelter" schemes. Rather, TRAC leases are very legitimate and efficient business transactions that benefit the lessor and lessee alike. TRAC leases constitute the most prevalent form of automobile lease and have been widely used in the industry for more than 30 years. I remain firmly convinced today, as I was more than two years ago when I first introduced legislation on this subject, that allowing Treasury; to finalize its regulation on this subject would cause considerable harm and disruption to the motor vehicle industry and consumers without any redeeming benefit to the Treasury.

I also call to your attention that there are 20 Members of the Committee on Ways and Means that are cosponsors of the bill, divided on both sides of the aisle.

Mr. Chairman, with your permission I would like to include in the record at this point a short statement that elaborates some of the points I have made.

We would not have a need to be here today if the TEFRA provisions on this subject had followed the substance of a bill I introduced in 1981. The issues presented should never have arisen, but since they have, I recommend and request that H.R. 1607 or provisions of equivalent effect be enacted promptly.

Tax Equity and Fiscal Responsbility Act of 1982 [TEFRA]

(PUBLIC LAW 97-248; 96 STAT. 324, AT PAGES 447 AND 448)

SEC. 210. MOTOR VEHICLE OPERATING LEASES.

(a) In General.—In the case of any qualified motor vehicle agreement, the fact that such agreement contains a terminal rental adjustment clause shall not be taken into account in determining whether such agreement is a lease.

(b) Definitions.—For purposes of this section—

(1) Qualified motor vehicle agreement.—The term "qualified motor vehicle agreement" means any agreement with respect to a motor vehicle (including a trailer)—

(A) which was entered into before—

(i) the enactment of any law, or

(ii) the publication by the Secretary of the Treasury or his delegate of any regulation,

which provides that any agreement with a terminal rental adjustment clause is not a lease,

(B) with respect to which the lessor under the agreement—

(i) is personally liable for the repayment of, or

(ii) has pledged property (but only to the extent of the net fair market value of the lessor's interest in such property), other than property subject to the agreement or property directly or indirectly financed by indebtedness secured by property subject to the agreement, as security for,

all amounts borrowed to finance the acquisition of property subject to the agreement, and

(C) with respect to which the lessee under the agreement uses the property subject to the agreement in a trade or business or for the production of income.

(2) TERMINAL RENTAL ADJUSTMENT CLAUSE.—The term "terminal rental adjustment clause" means a provision of an agreement which permits or requires the rental price to be adjusted upward or downward by reference to the amount realized by the lessor under the agreement upon sale or other disposition of such property.

H.R. 1607

A BILL To amend the Internal Revenue Code of 1954 to make it clear that certain motor vehicle operating leases are leases.

EXPLANATION

H.R. 1607 makes clear that a terminal rental adjustment clause (TRAC) in a motor vehicle operating lease will not be taken into account in determining whether an agreement is a lease for Federal tax purposes if the lessor either is personally liable for repayment or has pledged certain other property as security for amounts borrowed to finance the acquisition of the property. The bill would be effective for all agreements regardless of whether they were entered into before or after the effective date of the act.

A terminal rental adjustment clause (TRAC) is a provision in an agreement that permits or requires an adjustment in the rental price based on the amount realized on the disposition of the property at the termination of the lease. (For description of what a TRAC lease is, see below.)

H.R. 1607 provides the same rules as provided by section 210 of TEFRA (attached), except for two modifications:

(1) The general rule provided by the bill can be terminated or modified only by Congress.

(2) The general rule is extended to property leased for personal use.

Enactment of this bill will settle a controversy that many Members thought should never have arisen and that was thought to have been settled by section 210 of TEFRA. Section 210 permitted the general rule to be terminated either by further act of Congress or by the publication of a regulation providing that any agreement with a TRAC clause is not a lease. However, the legislative history makes clear that Congressional sponsors of section 210 expected this regulatory power to be exercised only under extraordinary circumstances and then only after completion of tax policy and economic impact studies.

With great haste and without the economic or other studies contemplated by sponsoring Members of Congress, a regulation labeled "interpretative" was proposed less than 3 months after the enactment of TEFRA. No Regulatory Impact Analysis required by Presidential Executive Order 12291 was made on the alleged ground that the proposed rule is not a major rule. No Regulatory Flexibility Analysis was made on the alleged ground that the proposed rules are interpretative.

The bill, basically, is revenue neutral. Attached is the revenue estimates by the staff of the Joint Committee on Taxation for S. 1161, an identical bill.

The bill is supported by motor vehicle lessors, manufacturers, dealers, workers, and users.

REASONS

The need for H.R. 1607 arises from efforts the IRS recently has made to change the traditional federal tax treatment of TRAC leases both as to commercial TRAC leases to business users and as to consumer TRAC leases to personal users. The treatment traditionally accorded such leases for over 30 years, both by lessors and by the IRS on audit of their tax returns, was to treat the lessor as the owner of the vehicle and as the party entitled to depreciation and other capital cost recovery tax allowances. The change sought by the IRS would treat the lessee instead of the lessor as the owner and deny capital cost recovery tax allowances to the lessor, shifting them instead to the lessee if he is a business user.

The IRS has attempted to make this change not by seeking Congressional enactment of a change in the law, but by administrative actions alone. Initially the IRS attempted to impose this change both retroactively and prospectively by disallowing capital cost recovery tax allowances on its audit of lessors' tax returns, and in pursuit of the audit tax deficiencies in litigation in the courts. However, since the enactment in 1982 of section 210 of TEFRA, it has sought to accomplish that result prospectively as to commercial leases through a regulation it proposed in November 1982, just 81 days after Congressional enactment of section 210 expressing a contrary policy view, and it is still seeking to accomplish that result retroactively as to consumer leases through audits and litigation.

The basic purpose of H.R. 1607 is to permit continuation of the traditional tax treatment of TRAC leases—which is to disregard the presence of TRAC clause in determining whether to respect a lease as such for tax purposes—unless and until Congress enacts a further law providing that an agreement with a TRAC clause is not a lease. H.R. 1607 would permit continuation of such traditional tax treatment in the case of commercial leases for business use and consumer leases for personal use, whether entered into before or after its enactment. Enactment of H.R. 1607 would have the effect of requiring the IRS and the Treasury to persuade Congress that it would be good tax policy and good economic policy to change the traditional tax treatment of TRAC leases as true leases for federal tax purposes.

WHAT IS A TRAC LEASE?

In a typical TRAC lease transaction, at the end of the lessess' use of a vehicle, the lessor takes the vehicle back from the lessee (who usually wants to be freed of the task of selling it), sells it on the open used car market at the best price obtainable, and then adjusts the rent by paying a refund to or collecting a deficiency from the lessee, to make up for any difference there is between the resale price actually realized from sale of the vehicle on the open market and the estimated or projected resale value of the vehicle that was used by the parties at the beginning of the lease in setting the amount of the rent payments. A typical vehicle TRAC lease transaction is NOT one in which the lessee is given an option to purchase the vehicle at the end of the lease term and certainly is NOT one in which the lessee is given an option to purchase the vehicle at a price that is nominal in relation to its actual market value at the end of the lease term. The TRAC vehicle lease was devised in the market place more than 30 years ago for the non-tax, business purpose of providing a financial incentive to the lessee user, who is the party to the lease transaction who is best able to control the cost of using the caring for the vehicle, to maintain the vehicle properly. That is done by providing that the lessee will hear the exact costs of the change in value of the vehicle that results during the lease term from his caring or failing to care for it.

Chairman **Stark**. What happens if you include all forms of leasing?

Mr. **Gibbons**. There are not many bills that come before any of our committees that make money.

Chairman **Stark**. Who is the witness who is jumping to catch the plane?

Tell me your name.

Mr. **Goldman**. I am Bernard Goldman. I am from the bay area, Congressman, and I do not have a formal presentation. I just have some notes, and my address will be fairly brief.

STATEMENT OF BERNARD GOLDMAN, PRESIDENT, BANKERS LEASING CORP., SAN MATEO, CALIF.

Mr. **Goldman**. I am president and chief executive officer of Bankers Leasing Corp. headquartered in San Mateo, Calif., and I want to speak in support of H.R. 1607.

Our company, Bankers Leasing, since 1955 has been offering terminal rental adjustment clause motor vehicle leases dealing predominantly with the public utility companies in the country.

In listening to the Treasury testimony before, I would like to make a distinction, and that is, these are real leases. These leases have been utilized since the early 1950's, and the reference to the safe harbor lease we think is incorrect.

The safe harbor lease was part of the Economic Recovery Tax Act of 1981. We are supporting this as a real lease which happens to have a terminal rental adjustment clause within it. Over the years this form of lease is the most widely used form in the public utility industry. Our own company presently owns 35,000 vehicles, virtually all of which are manufactured domestically, and we understand——

Chairman STARK. Could you supply the Chair at some point, Mr. Goldman—a phone call would do—with how many of those 35,000 vehicles would have had an initial selling price over $15,000?

Mr. GOLDMAN. Very few.

In dealing with public utilities, Congressman, for the most part, those meter readers drive very, very inexpensive cars. There may be one or two executive cars, but there is not——

Chairman STARK. So you would have no objection to the other bill?

Mr. GOLDMAN. That is not the field in which we are in.

Chairman STARK. Would you have any objection if other forms of leasing equipment were included under the same provisions as automobiles?

Mr. GOLDMAN. Well, we are dealing primarily with motor vehicles and trailers here. I think I would like to give some consideration to that other concept.

We do, however, in these 35,000 vehicles we now own which represent dozens of thousands more we have accumulated over the years which have come in and out of our program, they have been traded in. We understand that the industry in total owns something like 4 million vehicles, representing approximately a $38 billion investment. In our own portfolio, that we have the privilege of leasing to approximately one-third of the Nation's public utility companies, they are represented in virtually every State within the United States.

We are a champion of something known as a revolving lease which permits our lessee to automatically replace a wornout vehicle with a new vehicle. And in citation of the low cost and the economic stability of the program we offer, we have had numerous programs in effect with our corporate lessees that have been in place for more than 25 years. And I can assure you these major corporations, their financial executives have looked at the transactions periodically to determine whether or not they continue to be economically viable. And I think having these programs in effect for all of these years certifies as to its low cost.

In addition, the companies we deal with have access—they are major corporations—they have access to the capital markets, and they have alternatives available to them. So if for any reason, TRAC motor vehicle leasing is not the way to go, they have alternatives available and will take that opportunity to switch to these alternatives.

This program works and it works well. Some of the best financial brains among our lessees' treasurers and financial executives in continuing to review the program have continued to implement it.

In addition, since we deal with public utility companies predominantly throughout the country, it has been our practice to buy our vehicles at the local level. We generally deal with motor vehicle dealers that are located near the utility service area so that if for any reason our ability to purchase these vehicles were impacted by the Treasury regulation which has been proposed, we could have a negative impact on local dealers on a national basis.

The economic benefits of the TRAC motor vehicle lease are based upon a 30-year history of stability. That is tax, regulatory and other areas. The certainty of the tax treatment is very important as part of the economic benefit.

In the case of our public utility lessees which report to their local commissions, to our knowledge no public utility commission in any instance has taken a negative position with respect to the TRAC motor vehicle lease. On the contrary, there are some instances where they have encouraged the utility to enter into these leases as a low cost form of fleet management.

If a higher cost program were forced upon us and the customers we serve, that cost must be flowed through to the consumer. There just is no other alternative.

As I understand it, lessees, lessors, domestic automobile manufacturers, labor, automobile dealers are in favor of this prospective legislation. Under the TRAC lease that Congressman Gibbons was kind enough to refer to, the lessee has a financial incentive to maintain the vehicle in good condition, because if he does, ultimately it will reduce his rental costs.

Therefore, we conclude that the lease is a better one for the lessee. It certainly is better for the lessor because it enables him to fix precisely his cost, and it is better for the customer.

And since, according to the Joint Committee staff, it is about a $91 million revenue enhancement to Treasury, it seems to us in continuing this program no one loses. It is a very sound and constructive program.

We believe that the disruption of it would cause a loss of domestic car sales, and we submit that the industry should be permitted to continue to function as it has over the past 30 years.

Thank you very much.

Chairman **STARK**. Thank you.

And if you get going right now, you can make the 5:30 plane back to San Francisco.

Mr. **GOLDMAN**. I appreciate it.

Chairman **STARK**. I would suggest to the remaining members of the panel that those who have prepared remarks will find them included, without objection, in their entirety in the record, and I am sure you all are thoroughly familiar with the issue. To the extent you could summarize your remarks or concentrate on those issues which may be unique to your particular group, it would be appreciated and would perhaps expedite the hearings for us.

Mr. Penn is chairman of the American Automobile Leasing Association. He was scheduled to be the first witness.

Do you want to proceed?

Mr. **PENN**. Yes, indeed.

STATEMENT OF A. SAMUEL PENN, CHAIRMAN, AD HOC TAX GROUP OF U.S. MOTOR VEHICLE LESSORS, LESSEES, DEALERS, MANUFACTURERS, WORKERS, AND USERS, AND PRESIDENT, AMERICAN AUTOMOTIVE LEASING ASSOCIATION

Mr. **Penn.** I am Samuel Penn, and I am the chairman of an ad hoc group of motor vehicle lessors, manufacturers, dealers, workers and users. We are all working together in support of prompt enactment of H.R. 1607. And with me on the panel to answer questions is John Cartwright of the Motor Vehicle Manufacturers Association; and Dale Wickham, the attorney for our ad hoc group.

I request at this point that a telegram sent on November 1 to the chairman and the members of this subcommittee and signed by 15 executives of the participants in our ad hoc group in support of 1607 be made a part of the record.

Chairman **Stark.** Without objection.

[The material follows:]

[Telegram]

Washington, D.C., November 1, 1983.

Re Need for enactment this year of amendment accomplishing purposes of H.R. 1607 re motor vehicle trac leases.

Hon. Fortney H. Stark,
Chairman, Subcommittee on Select Revenue Measures, Committee on Ways and Means, U.S. House of Representatives, Capitol Hill, D.C.

Dear Mr. Stark: As the chief executive officers of organizations in a group of U.S. automotive manufacturers, lessors, dealers, and workers needing enactment this year of H.R. 1607, we express our earnest hope that you will find it possible to accept the text of H.R. 1607 as a part of a tax bill being developed for approval by your committee for enactment into law this year.

The effect of H.R. 1607, which is the subject of hearings before your subcommittee this Thursday, November 3, is to amend sec. 210 of TEFRA to (1) permit the rule of sec. 210 to be changed only by law enacted by Congress and not simply by Treasury regulation, and (2) consistent with a recent revenue ruling, apply the rule without regard to business or personal use by the lessee.

H.R. 1607 has only a negligible revenue effect annually, and will raise only 91 million dollars in revenue over the 5 fiscal years 1984-88 according to joint committee staff estimates.

We deeply appreciate all the efforts made to date to bring about this result, and want you to know of our readiness to help in any way we can.

Very sincerely yours,

A. Samuel Penn, President, American Automotive Leasing Association, Milwaukee, Wisconsin; Bernard Goldman, President, Bankers Leasing Corporation, San Mateo, California; James S. Frank, President, Wheels, Inc., Chicago, Illinois; William J. Fleming, President, Dart and Kraft Financial Corp., Northbrook, Illinois; Lee A. Iacocca, Chairman of the Board and Chief Executive Officer, Chrysler Corporation, Detroit, Michigan; Roger B. Smith, Chairman of the Board, General Motors Corporation, Detroit, Michigan; H. A. Poling, Executive Vice President, Dearborn,Michigan; N. Bud Grossman, President and Chairman of Gelco Corporation, Eden Prairie, Minnesota; Jerome W. Geckle, Chairman, President and Chief Executive Officer, PHH Group, Inc., Hunt Valley, Maryland; John W. Salzer, President, Dresser Leasing Corporation, Pittsburgh, Pennsylvania; David R. Kerr, President, Kerr Management Corporation, Englewood, Colorado; D. E. Mundell, President, and Chief Executive Officer, U.S. Leasing Internationl, San Francisco, California; Bemis A. Rolfs, President, National Car Rental, Minneapolis, Minnesota; William C. Turnbull, President, National Automobile Dealers, Association, McLean, Virginia; Gerald S. McDonough, Chairman and Chief Executive Officer, Leaseway Transportation Corp., Cleveland Ohio.

Mr. PENN. H.R. 1607 would prevent the IRS from reversing the rule of section 210 of TEFRA that a TRAC clauses is not to be taken into account in determining whether certain motor vehicle leases are to be treated as such for tax purposes.

A TRAC clause is one where the rent is retroactively adjusted at the end of the lease term by reference to the resale price of the vehicle in relation to its projected value. The bill would also apply to consumer leases that are not now covered by section 210.

The course of action being pursued by the IRS will provide no benefit to the Treasury or to the public, but it will cause substantial injury to the motor vehicle industry, to lessors, to new car dealers, to manufacturers, to their workers, and to lessees because of an increase in prices.

Furthermore, the IRS has proposed regulations in a manner that is contrary to the intent of Congress.

Mr. Chairman, we should not be forced to change our business practice that has developed over 30 years. Frankly, we do not understand why the IRS wants us to change a practice that has proven so effective.

TRAC leases account for upwards of 16 percent of Detroit's motor vehicle output. They comprise 70 percent of all motor vehicle leases because they are, in fact, the most efficient form of motor vehicle lease. They are designed to insure that the party best able to care for and maintain the vehicle, the lessee, will bear the full cost of use and possible abuse of the vehicle. The vehicle's condition, appearance and the extent of use are the factors that are important in determining the resale value of an automobile.

Motor vehicle TRAC leases are not tax motivated. Any other form of lease transaction will be less efficient and more expensive. This additional cost will result in a reduction of new vehicle sales. The lost sales will be harmful to lessors, new car dealers, manufacturers, and consumers.

It is worth noting that close to 100 percent of the vehicles used in commercial fleets are manufactured here in the United States. There is, in fact, no business, economic or tax policy reason why we should change a widespread efficient business practice that has been in use for more than 30 years.

The burden should not be on motor vehicle lessors to justify the way they have historically done business. The burden should be on the IRS to show why its proposed change, which will benefit no one and will raise no revenue, justifies the hardship that would be caused to all segments of the motor vehicle industry, its workers and consumers.

We cannot predict the long range of business reaction to an IRS change in the law. We can predict that leases for those few lessees unable to use their tax deductions will be restructured in a way that satisfies the IRS guideline.

We can also predict with certainty a period of substantial disruption during which new car deliveries to our lessees will come to a virtual halt while available alternatives are being studied.

The economic and revenue impact of these alternatives will be explained, if we have time, by Dr. Brannon. He and Emil Sunley have concluded that H.R. 1607 will be essentially revenue neutral and may even produce a small revenue gain to the government.

The IRS has acted in a manner contrary to the intent of Congress. Statements of the principal sponsors of legislation ultimately enacted as 210 of TEFRA clearly indicate that no IRS regulation was to be issued except under extraordinary circumstances supported by major——

Chairman STARK. I take exception to that. I was there and you were not, and I just want the record to show that is not the case.

Mr. PENN. Yet, without having conducted any studies whatsoever, the IRS issued its regulation on TRAC leases less than 3 months after TEFRA was enacted.

Now, Mr. Chairman, I am obviously not an economist, an accountant or tax lawyer.

[The prepared statement follows:]

STATEMENT OF A. SAMUEL PENN, CHAIRMAN OF AN AD HOC TAX GROUP OF U.S. MOTOR VEHICLE LESSORS, LESSEES, DEALERS, MANUFACTURERS, WORKERS AND USERS AND PRESIDENT, AMERICAN AUTOMOTIVE LEASING ASSOCIATION

SUMMARY

1. On behalf of an ad hoc group which includes motor vehicle lessors, dealers, manufacturers, workers and users, prompt enactment of H.R. 1607 is urged.

2. H.R. 1607 is a bill to make clear that TRAC clauses in certain operating motor vehicle leases (leases that provide for a retroactive rent adjustment at the end of the lease based on the difference between actual and estimated resale value) will not be taken into account in determining whether such leases are leases for federal income tax purposes.

3. Enactment of H.R. 1607 is necessary to prevent the IRS from pursuing a course of action that would force motor vehicle lessors to change the efficient way they have been doing business for over 30 years and in the process cause substantial injury to U.S. motor vehicle lessors, dealers, manufacturers, workers, and users without providing any significant benefit to the Treasury or the public.

4. TRAC leases are not mere tax avoidance devices but were developed long ago to meet the needs of business.

5. TRAC leases account for upwards of 16 percent of Detroit's annual output and account for nearly 70 percent of all motor vehicle leases.

6. The burden should be on the IRS to justify why it should be allowed to pursue a course of action that would be highly disruptive and which would impose a substantial hardship on business, labor, and consumers.

7. The legislative authority delegated to the IRS in section 210 of TEFRA should be removed as quickly as possible to prevent the IRS from continuing a course of action that is contrary to the intent of Congress.

8. As a matter of policy and fairness, the protection presently afforded motor vehicle business TRAC leases by section 210 of TEFRA should be extended to consumer leases of motor vehicles for personal use.

9. Technical purity does not justify the disruption and economic harm that would result from the IRS position, but the IRS position does not in fact achieve technical purity.

10. H.R. 1607 will place the policy decision that would be involved in forcing a change of 30 years of efficient business practice where that decision belongs—with Congress.

STATEMENT

Mr. Chairman, Members of the Committee, we thank you for the opportunity to testify today in support of H.R. 1607.

I am testifying in my capacity as chairman of an ad hoc group which includes within its participants a broad cross section of the entire motor vehicle industry—large and small motor vehicle lessors, automobile dealers, and U.S. motor vehicle manufacturers, workers, and users—and in my capacity as President of the American Automotive Leasing Association.[1]

I am Executive Vice President of PHH Group, Inc., which is headquartered in the Baltimore, Maryland, area. Accompanying me today on the panel is Bernard Goldman, President and Chief Executive Officer of Bankers Leasing Corporation, headquartered in San Mateo, California, which is a subsidiary of Southern Pacific Company, headquartered in the San Francisco area. Also accompanying me is counsel to the ad hoc group, Dale W. Wickham, to assist in answering any questions you may have.

The purpose of the ad hoc group is to support prompt enactment of H.R. 1670. H.R. 1607 makes clear that a terminal rental adjustment clause (TRAC) in a motor vehicle operating lease will not be taken into account in determining whether an agreement is a lease for Federal tax purposes if the lessor either is personally liable for repayment or has pledged certain other property as security for amounts borrowed to finance the acquisition of the property. The bill would be effective for all agreements regardless of whether they were entered into before or after its enactment.

A terminal rental adjustment clause (TRAC) is a provision in an agreement that permits or requires an adjustment in the rental price based on the amount realized on the disposition of the property at the termination of the lease. In a typical TRAC lease transaction, at the end of the lessees' use of a vehicle, the lessor takes the vehicle back from the lessee (who usually wants to be freed of the onerous requirements of motor vehicle ownership including the task of selling it), sells it on the open used car market at the best price obtainable, and then adjusts the rent by paying a refund to or collecting a deficiency from the lessee, to make up for any difference there is between the resale price actually realized from sale of the vehicle on the open market and the estimated or projected resale value of the vehicle that was used by the parties at the beginning of the lease in setting the amount of the rent payments. A typical vehicle TRAC lease transaction is NOT one in which the lessee is given an option to purchase the vehicle at the end of the lease term and certainly is NOT one in which the lessee is given an option to purchase the vehicle at a price that is nominal in relation to its actual market value at the end of the lease term. The TRAC vehicle lease was devised in the marketplace more than 30 years ago for the non-tax, business purpose of providing a financial incentive to the lessee user, who is the party to the lease transaction who is best able to control the cost of using and caring for the vehicle, to maintain the vehicle properly. That is done by providing that the lessee will bear the exact costs of the change in value of the vehicle that results during the lease term from his caring or failing to care for it.

H.R. 1607 provides the same rules as provided by section 210 of the Tax Equity and Fiscal Responsibility Act of 1982 ("TEFRA"), except for two modifications.

(1) The general rule provided by the bill can be terminated or modified only by Congress.

(2) The general rule is extended to property leased for personal use.

Enactment of this bill will settle a controversy that many members of Congress thought should never have arisen and that was thought to have been settled by section 210 of TEFRA. Section 210 permitted the general rule to be terminated either by further act of Congress or by the publication of a regulation providing that any agreement with a TRAC clause is not a lease. However, the legislative history makes clear that Congressional sponsors of section 210 expected this regulatory power to be exercised only under extraordinary circumstances and then only after completion of tax policy and economic impact studies.

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[1] The participants in the ad hoc group are: Lessors—PHH Group, Inc. and affiliates, Baltimore, Maryland; Gelco Corporation and affiliates, Minneapolis, Minnesota; Leaseway Transportation Corporation, Cleveland, Ohio; Wheels, Inc., Chicago, Illinois; Bankers Leasing Corporation (a subsidiary of the Southern Pacific Corporation), San Francisco, California; U.S. Fleet Leasing Company (a subsidiary of U.S. Leasing International), San Francisco, California; National Car Rental Systems (a subsidiary of Household International, Chicago, Illinois), Minneapolis, Minnesota; Dart & Kraft Leasing (a subsidiary of Dart & Kraft, Inc., Chicago, Illinois), Minneapolis, Minnesota; Kerr Management Corp., Denver, Colorado; Glesby Leasing, Houston, Texas; Moore Leasing, Portland, Oregon; AMI Leasing Group, Worcester, Massachusetts, and Providence, Rhode Island; American Automotive Leasing Association (AALA), Milwaukee, Wisconsin, and Washington, D.C.; Dresser Leasing Corporation (a subsidiary of Dresser Industries, Dallas, Texas), Pittsburgh, Pennsylvania; RTR Transportation Corp., Rochester, New York; Lessees—Various lessee organizations around the country also are cooperating informally in the work of the ad hoc tax group; Dealers—National Automobile Dealers Association (NADA) and numerous member dealer organizations around the country, Washington, D.C.; Manufacturers—General Motors Corporation, Detroit, Michigan; Ford Motor Company, Detroit, Michigan; Chrysler Corporation, Detroit, Michigan; Labor—United Auto Workers (UAW), Washington, D.C.

With great haste and without the economic or other studies contemplated by sponsoring members of Congress, a regulation labeled "interpretative" was proposed less than 3 months after the enactment of TEFRA. No Regulatory Impact Analysis required by Presidential Executive Order 12291 was made on the alleged ground that the proposed rule is not a major rule. No Regulatory Flexibility Analysis was made on the alleged ground that the proposed rules are interpretative.

The bill is essentially revenue neutral. The Staff of the Joint Committee on Taxation estimates that the bill would increase federal revenues by $91 million over the next five years. We understand that Treasury is not in disagreement with the Joint Committee revenue estimates.

The need for H.R. 1607 arises from efforts the IRS recently has made to change the traditional federal tax treatment of TRAC leases both as to commercial TRAC leases to business users and as to consumer TRAC leases to personal users. The treatment traditionally accorded such leases for over 30 years, both by lessors and by the IRS on audit of their tax returns, was to treat the lessor as the owner of the vehicle and as the party entitled to depreciation and other capital cost recovery tax allowances. The change sought by the IRS would treat the lessee instead of the lessor as the owner and deny capital cost cost recovery tax allowances to the lessor, shifting them instead to the lessee if he is a business user.

The IRS has attempted to make this change not by seeking Congressional enactment of a change in the law, but by administrative actions alone. Initially the IRS attempted to impose this change both retroactively and prospectively by disallowing capital cost recovery tax allowances on its audit of lessors' tax returns, and in pursuit of the audit tax deficiencies in litigation in the courts. However, since the enactment in 1982 of section 210 of TEFRA, it has sought to accomplish that result prospectively as to commercial leases through a regulation it proposed in November 1982, just 81 days after Congressional enactment of section 210 expressing a contrary policy view, and it is still seeking to accomplish that result retroactively as to consumer leases through audits and litigation.

The basic purpose of H.R. 1607 is to permit continuation of the traditional tax treatment of TRAC leases—which is to disregard the presence of a TRAC clause in determining whether to respect a lease as such for tax purposes—unless and until Congress enacts a further law providing that an agreement with a TRAC clause is not a lease. H.R. 1607 would permit continuation of such traditional tax treatment in the case of commercial leases for business use and consumer leases for personal use, whether entered into before or after its enactment. Enactment of H.R. 1607 would have the effect of requiring the IRS and the Treasury to persuade Congress that it would be good tax policy and good economic policy to change the traditional tax treatment of TRAC leases as true leases for federal tax purposes.

Enactment of H.R. 1607 is necessary to prevent the Internal Revenue Service from continuing a course of action that would force motor vehicle lessors to change the efficient way they have been doing business for over 30 years, and in the process cause substantial injury to U.S. motor vehicle lessors, dealers, manufacturers, workers and users, without providing any significant benefit to Treasury and the public. Enactment of H.R. 1607 will also prevent the IRS from continuing a course of action that is contrary to the intent of Congress, and will place the policy decision that would be involved in forcing a change of 30 years of efficient business practice where that decision belongs—with Congress.

Lessees should not be forced to change 30 years of efficient business practice to a less efficient practice that will harm all segments of the motor vehicle industry, its workers, and motor vehicle users

Motor vehicle lessors should not be forced to change their business practice. The TRAC lease was developed over 30 years ago to meet the needs of business. Today it is a business practice that accounts for upwards of 16 percent of Detroit's annual output. It is a business practice that today accounts for nearly 70 percent of all motor vehicle leases. Motor vehicle TRAC leases have achieved this widespread use and importance because they constitute the most efficient form of motor vehicle lease transaction. They are efficient because they ensure that the party best able to care for and maintain the vehicle—the lessee—will bear the full cost of use and possible abuse of the vehicle. Vehicle condition, appearance and extent of use are the factors that are most important in determining the resale value of an automobile.

Any other form of motor vehicle lease transaction will be less efficient and more expensive. "Wear-and-tear" clauses typically found in closed-end motor vehicle leases are not satisfactory substitutes for TRAC leases. They inevitably lead to costly and unpleasant disputes between lessors and lessees. These leases are also generally more expensive because the lessor must charge more rent to protect against the possibility of inadequate maintenance, excessive mileage, or a more demanding use of the vehicle than was anticipated at the inception of the lease.

A needless requirement to change current business practice will be costly to everyone involved. Initially, there will be a substantial disruption as business reevaluates its available options. During this period, there will be a substantial reduction in the number of new leases and vehicle deliveries. We anticipate this period will last at least three months and maybe as long as nine months. A three-month delay in vehicle replacements could mean 325,000 less new car purchases with a sales value of $3.7 billion. This is a loss that would never be recouped by lessors, dealers, and manufacturers.

After the initial period of disruption, less efficient and more expensive forms of leases will mean higher prices to users for the same vehicles, less business for motor vehicle lessors, dealers and manufacturers, and less jobs for workers. To the extent that business users would choose to own vehicles rather than continue leasing, the loss to the U.S. motor vehicle industry and its workers will be even greater. The loss that would be incurred by lessors is obvious. The loss that would be incurred by U.S. manufacturers and workers is perhaps less obvious, but nevertheless real. Nearly all vehicles used in commercial fleet leases are U.S. manufactured. This represents a sharp contrast to the percentage of user-owned vehicles that are U.S. manufactured. Industry studies also indicate that the average holding period for leased business vehicles is 28 months, compared to 32 months for user-owned vehicles. A four-month extension in the holding period of vehicles currently leased by business under TRAC leases would translate into a loss every year of 200,000 vehicle purchases worth $2 billion.

Thus, a requirement to change business practice will have serious adverse consequences not only to lessors and dealers, but to U.S. manufacturers and workers as well. But the harm that would be inflicted on U.S. motor vehicle lessors, dealers, manufacturers, workers and users is unnecessary. There is, in fact, no business, economic or tax policy reason to require motor vehicle lessors to change the efficient way they have done business for more than 30 years. Moreover, the burden should not be on motor vehicle lessors to justify the way they have done business for more then 30 years. The burden should be on the IRS to justify the hardship that would be caused by its proposal.

We understand the need for the IRS to be vigilant against transactions that are mere tax avoidance devices. Motor vehicle TRAC leases do not fit that mold. Indeed, most motor vehicle leases are not even tax motivated. Motor vehicle leasing companies expect to realize an economic profit from the leasing transactions which, for many such companies, is their principal source of income. The users typically choose to lease instead of own vehicles for sound business reasons unrelated to tax avoidance, such as: (1) the use of "off-balance sheet financing" which enables businesses to use late model vehicles without impairing their financial statements, (2) avoidance of a large initial down payment thereby conserving working capital, (3) the ability to use late model vehicles without violating potential restrictions on borrowings or regulatory agreements, and (4) the ability to have use of late model vehicles without being subject to onerous federal, state and local law requirements relating to motor vehicled ownership. In short, TRAC leases are business transactions entered into to benefit both parties to the transaction on a business and economic basis, and there is no tax policy reason which we can discern that would justify changing 30 years of efficient business practice.

Anticipated revenue effect if the IRS were allowed to force a change in existing business practice

Economic consultants to the ad hoc group, Emil M. Sunley and Gerard M. Brannon, have concluded that H.R. 1607 is essentially revenue neutral, and on balance would likely produce a small revenue gain. The staff of the Joint Committee on Taxation has also estimated a small revenue gain from enactment of the bill ($91 million for the five fiscal years 1984-1988). If the IRS were allowed to pursue a course of action to change existing law, the reaction among motor vehicle lessors and users would [illegible]ly vary. As previously stated, there will be a period of initial disruption during which business evaluates available alternatives, reeamines existing motor vehicle lease agreements, and the like. During this period, the replacement of vehicles currently leased by business may come to a virtual halt. Economic consultants to the ad hoc group estimate that a three-month delay in vehicle replacement would reduce federal revenues by $900 million. In the long term, several alternative forms of motor vehicle transaction may be used: (1) businesses may continue to lease automobiles under a different form of lease such as a "closed-end" lease; (2) businesses may purchase automobiles outright; or (3) TRAC leases may continue to be used with an upward adjustment of rent to reflect conditional sale treatment for tax purposes under which the user would be allowed the cost recovery allowances and investment tax credits. Of course, a combination of these alternatives is also possible. No one at this time can predict how the motor vehicle leasing industry and motor vehicle users would adapt if the IRS were allowed to continue its attempt to change existing law. It is predictable that in those few cases where the lessee could not use the cost recovery allowances and investment tax credits, the lease will be structured in a way that will satisfy IRS guidelines. Economic consultants to the ad hoc group have estimated that if all business lessee (other than those few business lessees who would be unable to use ACRS allowances and investment tax credits) were to continue use of TRAC leases that were treated as conditional sales agreements for tax purposes, the government would actually loss $85 million in tax revenue annually. The economic and revenue impact of H.R. 1607 is discussed in greater detail in separate statements submitted by Gerard M. Brannon and Emil M. Sunley.

Enactment of H.R. 1607 will prevent the IRS from continuing a course of action that is contrary to the intent of Congress

There is overwhelming evidence that the principal sponsors of legislation that ultimately was enacted as section 210 of TEFRA did not intend for Treasury to exercise an unfettered discretion in publishing a regulation to reverse the rule of section 210. Statements made for the record by principal sponsors of the legislation, such as Senator Bentsen, made it very clear that Congress did not expect the rule of section 210 to be reversed except in "extraordinary circumstances" and then only after Treasury had conducted policy-level studies showing a clear need for such a regulation. The IRS, in complete disregard of the intent of Congress, turned right around and published a proposed regulation to reverse section 210 less than three months after it was enacted. Of course, no policy-level studies were conducted by Treasury. Equally alarming is the failure of the IRS to comply with other procedural regulatory requirements, such as the preparation of a Regulatory Impact Analysis as required by Executive Order 12291 and a Regulatory Flexibility Analysis as required by the Regulatory Flexibility Act. The IRS determines that it was not subject to these requirements imposed on other agencies by the self proclamation that the proposed regulation is not a "major rule" (in disregard of the substantial damage that the regulation would cause to the motor vehicle industry, workers, and consumers) and that the proposed rules are merely "interpretative" (in disregard of the fact that the proposed regulation would reverse a statutory rule rather than interpret it). In view of the IRS history on this matter, the legislative authority delegated to it in section 210 should be removed by Congress as quickly as possible.

As a matter of fairness and policy, consumer leases of motor vehicles for personal use are entitled to the same protection as is presently afforded to motor vehicle business leases by section 210 of TEFRA

H.R. 1607 appropriately extends the protection presently afforded to motor vehicle business leases by section 210 of TEFRA to consumer leases of motor vehicles for personal use. There is no conceptual or policy difference between business leases and consumer leases. Furthermore, consumer leases are equally entitled to protection against an IRS change in audit position as are business leases.

The exclusion of consumer leases of motor vehicles from section 210 of TEFRA was done at the request of Treadury at the last moment during the Senate Finance Committee mark-up proceeding. The type of use by the lessee was not relevant in the proposal initially sought by the principal sponsors of the legislation, Senators Bentsen and Armstrong, nor in any of the other earlier legislative proposals on this subject. The Treasury request for the unusual limitation was probably prompted by an initial fear of a potential revenue loss, Although no detailed revenue estimate had been prepared on that aspect of the legislation. As explained in the Congressional Record in an exchange of correspondence between Senator Bentsen and Congressman Matsui, 128 Cong. Rec. E3867 (dailey ed., August 12, 1981), no negative inference was intended by the omission of consumer leases in section 210 of TEFRA. Economic consultants to the ad hoc group have concluded that extension of the rule set forth in section 210 of TEFRA to consumer leases should not result in a revenue loss, as discussed in detail in their statements submitted on H.R. 1607.

Appropriate consideration was not given to the tax policy or revenue implications of the personal use limitations in section 210 of TEFRA. Adoption of such an unusual rule distinguishing the lessor's tax treatment based on the type of use by the lessee should be made only by Congress after appropriate consideration of the tax policy and economic implications. As a matter of law and sound tax policy, there is no reasonable basis for distinguishing the lessor's tax treatment in motor vehicle transactions on the basis of how the lessee uses the property. Such a distinction would not only be unsound tax policy and law, but would create unnecessary compliance and administrative difficulties for taxpayers and the IRS.

Consumer leases are also entitled to the same protection against the retroactive application of an adverse change in longstanding IRS audit policy as are business leases. One of the purposes of section 210 of TEFRA was to prevent retroactive application of a new IRS audit policy. Before the change in IRS audit policy as reflected in a 1979 Technical Advice Memorandum, the longstanding IRS audit position was to recognize TRAC leases as true leases. *Leslie Leasing Co.*, 80 T C. 411 (1983). This longstanding audit position was the same for business leases and consumer leases. Consumer leases are entitled to the same protection against retroactive changes in IRS audit position as is afforded by section 210 of TEFRA to business leases. Consumer leases are also entitled to protection against future administrative attempts to change the law that are undertaken without appropriate policy and economic considerations.

TECHNICAL LEGAL CONSIDERATIONS

We have been told that the purpose of the IRS in pursuing its position on motor vehicle TRAC leases is to achieve what some regard as "technical purity." Even if technical purity were achieved, that is not sufficient reason to require lessors to change over 30 years of buisness practice with the resulting disruption and economic harm that would occur. While I am not a lawyer, and a detailed technical discussion of the law is beyond the scope of this statement, it is apparent that the proposed regulation is not as technically pure as the IRS would like one to believe. The position advocated by the IRS is based on the premise that a shifting of substantial risk to the property user causes the user to be treated as owner of the property. Application of such a test, which was rejected by the U.S. Supreme Court in *Frank Lyon Co.* v. *U.S.* 435 U.S. 561 (1978), leaves businessmen such as myself (as well as our counsel) wondering whether any leases would be treated as such for tax purposes. Any lessor in the business of leasing must shift risk to the lessee in one form or another if it is to remain in business. For example, so-called closed-end motor vehicle leases typically contain wear-and-tear clauses to shift substantial risks to the lessee. TRAC leases were developed as a more efficient substitute for the problems inherent in closed-end leases with wear-and-tear clauses. One is simply left wondering what type of lease could qualify under the test advocated by the IRS. Furthermore, we can only ask why the U.S. Tax Court, a court with special expertise in tax matters that hears only tax cases, failed to appreciate the technical merits of the IRS position and flatly rejected it.

CONCLUSION

H.R. 1607 would prevent the IRS from pursuing a course of action that would force motor vehicle lessors to needlessly change the efficient way they have been doing business for over 30 years. It would prevent the IRS from pursuing a course of action that will inevitably cause substantial injury to U.S. motor vehicle lessors, dealers, manufacturers, workers, and users without providing any corresponding benefit to Treasury and the public. H.R. 1607 would also prevent the IR[from continuing a course of action that is contrary to the intent of Congress. It will place the policy decision that would be involved in forcing a change in 30 years of efficient business practice exclusively with Congress where that decision belongs. We urge prompt enactment of H.R. 1607.

Chairman STARK. Just explain to me, Mr. Penn——

Mr. PENN. Yes, sir.

Chairman STARK. Let me just get the record straight here, please. The Senate amendment prevents the IRS—this is from the TEFRA report, the conference report—it prevents the IRS from retroactively denying lease treatment for certain motor vehicle leases, including leases of trailers, by reason of the fact that those leases contain terminal rental adjustment clauses. The provision does not address the legal effect of these clauses and does not prevent the Treasury from issuing regulations on a prospective basis addressing the legal effect of these clauses.

The Senate provision regarding terminal rental adjustment clauses applies only to leases where the lessee uses the property for business purposes. Also, the provision does not apply to leveraged leases financed with nonrecourse debt. That was the intention of Congress, and it is quite clear.

Mr. GIBBONS. Well, Mr. Chairman, as you know, this is my bill, and I was on the conference with you.

Chairman STARK. Did you sign the same report I did?

Mr. GIBBONS. Yes; but you did not read it, and neither did I. We did not have a chance to read it. I do not know what the hell the staff throws in those things, but they went a little further than I certainly would have gone.

I do not go around thinking you have to police the staff all the time. As I said, it was my bill. I thought Congress had reacted to the situation. I thought I had reacted to the situation. And I frankly do not like the Treasury going around behind my back and saying Congressman, you go to hell. That is what they said, in effect, to me.

I have no financial interest in this. I have no interest in it at all, except I have constituents who have problems like this. I lease the car. If I did not have a terminal rental adjustment clause in that, Pete, I would not give a damn what happened to the car.

Chairman STARK. Explain to me, Sam. You lease a car. If you do not use it for business, you are not entitled to an investment tax credit; is that right?

Mr. GIBBONS. I am not getting anything for it.

Chairman STARK. If you lease the car, the lessor does get an investment tax credit, does he not?

Mr. GIBBONS. Yes.

Chairman STARK. So somebody is getting a tax credit that would not exist if you purchased the car under a finance situation, and also, the lessor is getting depreciation which you and I cannot take for personal automobiles. And I am waiting for Mr. Sunley to walk us through the magic mirror into Wonderland to show how this additional tax credit and depreciation that would not be there for you and me, when transferred to these leasing companies, raises money for the Treasury.

Mr. GIBBONS. These are not Sunley's figures. They are Joint Committee figures.

Chairman STARK. There are new figures on their way, I might add, from the Joint Committee, and we hope to have them by 5 o'clock. It is my understanding there is some reexamination of those figures.

The next witness is Mr. Cartwright of Ford Motor Co., representing the Motor Vehicle Manufacturers Association.

STATEMENT OF JOHN F. CARTWRIGHT, FORD MOTOR CO., REPRESENTING MOTOR VEHICLE MANUFACTURERS ASSOCIATION OF THE UNITED STATES, INC.

Mr. CARTWRIGHT. Mr. Chairman, members of the committee, my name is John Cartwright. I am appearing on behalf of the Motor Vehicle Manufacturers Association of the United States.

We urge the immediate enactment of H.R. 1607 to prevent the IRS from asserting its regulatory power to change the existing law respecting open-end leasing. There are in excess of 3 million motor vehicles under lease in the United States, of which approximately 69 percent are open-end leases containing terminal rental adjustment clauses, ordinarily called TRAC's.

The open-end lease is not a tax-oriented document as suggested by the Treasury representative earlier. It has been in existence for over 30 years. It has been through the gamut before we ever had ITC or rapid methods of depreciation. It provides the lowest rental payments for the lessee by giving the lessee an incentive to take care of the vehicle.

The TRAC, as has been described before, provides an incentive for the lessee to take care of the car in the best method, because that is the primary issue with respect to what you get at the final stage when the car is sold.

The proposed regulation would eliminate the TRAC and would result in a closed-end lease constituting the only lease recognized for tax purposes. This would result in a substantial increase in rental rates and threaten the survival of the leasing industry. The larger leasing companies would be reluctant to do business in an atmosphere in which they must accept all of the risk of loss at the time the lease terminates.

The smaller and weaker leasing companies could not accept the risk due to the restrictions placed upon them and the limitations placed upon them by their financing sources. The rental rates would necessarily be higher for the closed-end lease to compensate the lessor for the additional risk and to reflect the higher interest rates the financing sources charge lessors for closed-end leases. This approximates 1½ to 2 percent across the country of increased finance charges for closed-end leases due to the additional risk placed on the lessor.

Failure to enact H.R. 1607, with the corresponding promulgation of the proposed regulation, would be disruptive to an established system of orderly distribution. It would surely cause delays in the ordering of vehicles by the fleet lessees while they determined the best economics of either to purchase or lease.

A study prepared by the American Automotive Leasing Association indicates the holding period for fleets that own their own vehicles exceed that for those which lease vehicles by approximately 4 months, and that for each month of delay it results in 49,000 lost vehicle orders. A 4-month delay from the uncertainty of a change in the tax law would interpolate to 200,000 vehicles per year of lost sales with consequent production cutbacks and increased unemployment.

The proposed regulations are contrary—Mr. Chairman, I know that you were here and part of this committee—but they appear to be contrary to the congressional intent of section 210 of TEFRA as reflected in correspondence between Congressman Matsui of California and Senator Bentsen of Texas, appearing in the Congressional Record of August 12.

Chairman **Stark**. Senator Bentsen was a party to the conference, but my good friend, Congressman Matsui, was not.

Mr. CARTWRIGHT. In that correspondence they indicated the change was to be effected by Treasury regulations only in the most extraordinary circumstances. In its haste to unilaterally change the law, the IRS violated congressionally and Presidentially prescribed standards of promulgating new administrative rules. It disregarded the requirements of the Regulatory Flexibility Act of 1980 and its mandate for a regulatory flexibility analysis. It abrogated the requirements of the Executive Order 12-291 in the preparation of a regulatory impact analysis.

Moreover, the executive order provides that rulemaking action cannot be undertaken unless the potential benefits to society for the regulations outweigh the potential cost to society.

The proposed regulations would increase the rental to consumers, provide no additional revenue to the Government because the business lessee would receive the ITC and the ACRS. In fact, the proposed regulations are more likely to cause a loss of revenue to the Government because the tax basis of ITC and ACRS would be higher in the hands of the lessee than the cost basis in the hands of the lessor who would otherwise claim the tax.

Prompt enactment of H.R. 1607 is required this session of Congress to eliminate the unfavorable economic impact that the uncertainty of the tax law may have on the leasing industry and its consequent effect on sales of motor vehicles by the U.S. manufacturers in this important segment of the business.

Thank you.

[The prepared statement follows:]

STATEMENT OF JOHN F. CARTWRIGHT ON BEHALF OF THE MOTOR VEHICLE MANUFACTURERS ASSOCIATION OF THE UNITED STATES, INC.

SUMMARY

I. Enactment of H.R. 1607 Required to Prevent IRS from Asserting Its Regulatory Power to Change the Existing Tax Law Respecting Open-end Motor Vehicle Leases.

A. Magnitude of the effect of the legislation.

II. Development of the Open-End Lease and its Cost Effectiveness

A. Aspects of open-end lease and its saving to lessee.

B. Proposed regulations would eliminate TRAC and result in only closed-end leases recognized as leases for tax purposes which would cause higher rental rates.

III. Benefits to Economy from not Changing Automotive Leasing Methods.

A. Change would have disruptive effect on an established system of distribution.

B. Change would cause delays in ordering by fleet lessees.

1. Result in sales loss of 49,000 vehicles per month of delay.

2. Result in production cutback and further unemployment.

IV. Proposed Regulations are Contrary to Congressional Intent of Section 210 of TEFRA

A. Congressional record indicates change was to be effected by Treasury regulations only in the most extraordinary circumstances.

B. In haste to unilaterally change law, IRS violated Congressional and Presidentially prescribed standards for promulgating new administrative rules.

1. Disregard of Regulatory and Flexibility Act of 1980 and its mandate for a Regulatory Flexibility Analysis.

2. Disregard of Executive Order 12291 and the preparation of a Regulatory Impact Analysis.

3. Benefits to society from regulations do not outweigh cost to society.

STATEMENT

Mr. Chairman, members of the Subcommittee, my name is John F. Cartwright and I am testifying on behalf of the Motor Vehicles Manufacturers Association of the United States, Inc. and its constituent members,[1] who enthusiastically support H.R. 1607.

H.R. 1607 will prevent the Internal Revenue Service through its regulatory power from changing the long standing tax treatment of "open-end" vehicle leases which have been used in the great majority of instances for the past 30 years throughout the automobile and truck leasing industry.

Even with the depressed market which has existed for the last several years it is estimated that substantially in excess of two million [2] cars and trucks are currently under lease and that approximately 69 percent [3] of these leases are "open-end" leases which contain a "terminal rental adjustment clause" commonly referred to as a TRAC.

(1) Development of Open-End Lease and Its Cost Effectiveness.—The open-end lease transaction, which is now threatened as a method of conducting business by the Service's proposed Regulation Section 1.68(f)(8)–12 [issued pursuant to Section 210 of the Tax Equity and Fiscal Responsiblity Act of 1982 (TEFRA) was developed in an intensely competitive industry in order to produce lower rental payments and give the lessee an incentive to maintain the lease vehicle in good condition. The TRAC provides that upon termination of the lease, the vehicle will be sold by the lessor and, if the proceeds from sale are less than the projected residual value established by the lessee and lessor upon execution of the agreement, the lessee is obligated to pay additional rent, but, if the sales proceeds exceed the residual value, the lessee receives a refund of rent. There is no option by the lessee to purchase. The open-end lease was developed in a market place involving extreme competition and enables the lessor to charge rents less than what otherwise would be required under a closed-end lease where the lessor must accept the entire burden for the value of the vehicle upon termination of the lease except for apparent body damage and excess mileage. The open-end lease has also virtually eliminated the controversy which otherwise arose between the lessor and lessee as a result of the squabble over the cost to fix body damage or excess wear and mileage.

The enactment of H.R. 1607 would remove the threat of the proposed Regulation to the survival of the leasing industry and continue to provide lower leasing costs to the consumer. Because the proposed regulations would require removal of the TRAC provision from an agreement in order to create a lease which is recognized for tax purposes, all leases would be "closed-end" and would place the full risk for the residual value of the vehicle on the lessor. Larger leasing companies would be reluctant to do business in an atmosphere in which they must accept the potential risk of the entire loss on resale at less than an anticipated projected residual value in view of the thousands of units they own and lease to the large fleet operations. The smaller or weaker leasing firms could not accept this risk due to the restrictions and limitations which would be imposed by their financing sources, forcing many of the leasing firms out of business. If lessors offered only closed-end leases, the cost of leasing to the consumer would rise considerably since rental payments on closed-end leases are necessarily higher than those under open-end leases in order to compensate the lessor for assuming the full risk of loss that may be incurred upon sale of the vehicle at lease termination.

(2) Benefits to Economy From Not Changing Automotive Leasing Methods.—The failure to enact H.R. 1607 with the corresponding promulgation of the proposed Regulations (Reg. Section 1.168(f)(8)–12) by the Treasury would have a disruptive effect on an established system of orderly distribution of automobiles and trucks through the fleet leasing network. It undoubtedly would wreak havoc with industry lease transactions and many fleet lessees would purchase their vehicles because of the increased cost of leasing which results from the closed-end lease and the uncertainty

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[1] MVMA represents U.S. automobile, truck, and bus manufacturers producing more than 99 percent of all domestic motor vehicles. MVMA members include: American Motors Corporation; Chrysler Corporation; Ford Motor Company; General Motors Corporation; International Harvester Company; M.A.N. Truck & Bus Corporation; PACCAR Inc.; Volkswagen of America, Inc.; and Volvo North American Corporation.

[2] See Senate Report No. 94–590 pertaining to the Consumer Leasing Act of 1976 in which the Senate Report under the subtitle "Need for the Legislation" stated that "as of 1974, 2.8 million, about 26 percent of the total number of cars made, were leased, and 36 percent of this total was leased to individuals."

[3] Runzheimer and Company, Inc., Rochester, Wisconsin, reported in its "1980 Survey and Analysis of Business Car Policies and Costs" (p. E–10) that approximately 69 percent of automobile leases were rent adjustment leases. The statistics from the Runzheimer survey are set forth in a consulting economist's study prepared by Robert R. Nathan Associates, Inc., in connection with the consideration of the investment tax credit provision of the Economic Recovery Act of 198. on pages 82–86.

of the tax consequences. There is no questions that delays in ordering new vehicles would occur while the management of fleet leasing customers determine the best economics of either to buy or lease.

Such delays would cause substantial economic hardship since a statistical study prepared for the American Automotive Leasing Association by Robert R. Nathan Associates, Inc. in 1981, "The Effectiveness of the Accelerated Cost Recovery System and Alternative Tax Incentives in Inducing Investment in Short Term Assets," indicates that the average vehicle use time for fleet users who own their own business fleets was approximately 32 months compared to the average vehicle use time of 28 months for fleet users who leased their business fleets. The study also indicated that for every month the holding period increased for business vehicles it resulted in 49,000 lost sales each year. A three or four month loss of sales at the magnitude of 200,000 vehicles is very significant and would result in production cutbacks by the manufacturers as well as higher unemployment at the manufacturers and dealerships.

(3) Proposed Regulations Are Contrary to Congressional Intent of Section 210 of TEFRA.—The "Confirmation of Congressional Intent" for Section 210 of TEFRA was set forth in the Congressional Record, dated August 12, 1982 (Vol. 128, E 3869), pursuant to an exchange of correspondence between Congressman Matsui of California and Senator Bentsen. In urging the support of his colleagues, Senator Bentsen, in his letter referring to himself and Senator Armstrong, made it clear that a change should be effected by prospective Treasury Department regulations only in the most extraordinary circumstances. In its haste to change the law unilaterally, the Internal Revenue Service has not only abrogated the intent of Congress as expressed by Senator Bentsen but has also violated Congressional and Presidentially prescribed procedural standards for promulgating new administrative rules.

The Service perfunctorily concluded that its proposed regulations are merely interpretive and that the small business protective requirements of the Regulatory Flexibility Act of 1980 and its mandate for a Regulatory Flexibility Analysis were not required. The error of this conclusion is demonstrated by the fact that the current law as set forth in Section 210(a) of TEFRA provides that the existence of a terminal rental adjustment clause shall not be taken into account in determining whether such an agreement is a lease. The intent of Congress, as previously stated, indicated that change would be effected by prospective regulations only in the most extraordinary circumstances. Indeed, Section 210 of TEFRA places no obligation or requirement on the Commissioner to issue the proposed regulations which would change the law.

Section 210(b) of TEFRA by its specific language provides that the current status of the law as set forth in Section 210(a) cannot be changed unless Congress makes a "legislative" or "substantive" change by enacting legislation or the Treasury publishes regulations. It, therefore, is completely irrational and irresponsible to contend that Congress did not also intend that any change in the law by the Treasury was anything less than "substantive" or "legislative" in nature, if Congress could only make such a change by legislation.

The Service also dogmatically determined that the proposed regulations did not constitute a "major rule" under Executive Order 12291 and that preparation and consideration of a Regulatory Impact Analysis was therefore not required. If any analysis had been conducted by the Service, it would have become obvious that implementation of the proposed regulations would have an economic effect which would meet each of the definitional criteria for a major rule. For example, if you assume under the most conservative approach that the lessor would only increase the rental charge by the amount of the ITC benefit it lost, then the cost to the lessee would increase by $540 per unit based on the average cost of leased vehicles for 1982 of approximately $9,000. Using the conservative approach, it would only require that 185,186 lease units be placed in service to reach an annual impact on the economy of $100 million or more. This alone would cause the regulation to constitute a "major rule" under Section 1(b) of the Order, considering the fact that far in excess of a million vehicles are currently being leased for business purposes pursuant to agreements containing a TRAC.

Section 2(b) of the Executive Order directs that rulemaking action cannot be undertaken unless the potential benefits to society for the regulations outweigh the potential costs to society. The proposed regulations would provide no additional revenue to the Government since the business lessee would be entitled to the ITC and ACRS. In fact, the proposed regulations would more than likely result in a revenue loss to the Government because the tax basis for the ITC and ACRS in the hands of the business lessee will be higher than the cost basis of a lessor who would have claimed the ITC and ACRS but for the proposed regulations. The increased rental to the lessee which will undoubtedly be charged by the lessor far outweighs any conceivable benefit to society, if any, resulting from the regulations.

It is most important that H.R. 1607 be enacted this year if we are to preclude the adverse effect of the proposed regulations which the Internal Revenue Service appears to be dedicated to promulgating in final form. Prompt enactment also is needed to eliminate the unfavorable economic impact that the uncertainty of the tax law may have on the motor vehicle leasing industry and its consequent effect on sales of motor vehicles to this important segment by the U.S. domestic automobile manufacturers. The Motor Vehicle Manufacturers Association urges your early enactment of H.R. 1607.

Thank you.

Chairman STARK. I would like the record to show this is the first time in my short legislative career I have ever heard of an exchange of letters creating any kind of legislative history. And secondly, we seem to skip over the fact that many lessees would not qualify for the investment tax credit or for the rapid depreciation; and therefore, you are creating extra tax benefits.

Insofar as TRAC leasing is concerned, if there is any witness at the table who operated a bigger TRAC leasing company than I did when I was in the banking business, let them come forward. And the idea that people maintain them that much better is false.

Mr. CARTWRIGHT. Mr. Chairman.

Mr. GIBBONS. I am going to argue with you a little bit about that. I have had some experience, too, Pete. It is not all one-sided here.

Chairman STARK. It is not.

I now call on Mr. Brannon and Mr. Sunley, both economic consultants, in whichever order you care to speak.

Mr. CARTWRIGHT. Mr. Chairman, may I reply to one statement?

Chairman STARK. Precisely. Go ahead.

Mr. CARTWRIGHT. The consumer use of the lease with a TRAC clause based upon the IRS interpretation would cause the instrument to constitute a conditional sale, in which event the consumer would be eligible to claim the imputed interest which would be higher than what the benefits would be.

Chairman STARK. Not if you guys are leveraging it yourself. You pay interest the same way anyone else does.

Mr. CARTWRIGHT. The benefit on the interest is much higher than the ITC and the ACRS.

Chairman STARK. And the interest you pay combined?

Mr. CARTWRIGHT. We would be paying interest, sure.

Chairman STARK. It all comes out the same. Everyone is paying interest.

Mr. Brannon and Mr. Sunley.

Mr. PENN. Mr. Chairman.

Chairman STARK. You will get a chance in a second. Let us finish the panel.

STATEMENT OF GERARD M. BRANNON, PH. D., AND EMIL M. SUNLEY, PH. D., ECONOMIC CONSULTANTS TO AD HOC TAX GROUP OF U.S. MOTOR VEHICLE LESSORS, LESSEES, DEALERS, MANUFACTURERS, WORKERS, AND USERS

Mr. BRANNON. Mr. Chairman, we have submitted statements which deal with the way in which we analyze the revenue estimate situation. I think I might be most useful by talking briefly about the kind of issue involved here and trying to respond to some of the approaches suggested by the Treasury witness earlier.

As I see the real situation, it is that, you have out in the real world a continuum of business arrangements. On the one extreme there is an outright sale, and on the other extreme, there is an outright lease. In between there can be all sorts of varieties of these things.

The Treasury has been quite concerned about trying to establish some consistent rules which they say might apply to everybody.

Now, because the situation is so complicated, these consistent rules are necessarily rather arbitrary. The Treasury has been inclined to focus on the presence of a TRAC clause. Other people here have talked about other features that make this look more like a lease. It is treated as a lease under State law. For borrowing and banking purposes it is a lease and so forth.

It seems to me from a revenue standpoint for the most part it does not make much difference. The net revenue effect involved here is very small compared to the total transactions. The most important thing is that you have a definite rule as to what any particular kind of transaction is.

In effect, the substance of the safe harbor leasing issue was that the Congress said this can be whatever you want to call it. Now, that turned out to be a pretty expensive way to operate, and the Congress thought you should not stick with free choice.

But my suggestion is so long as you have a definite rule, it does not really make a great deal of difference where you put it.

Now, basically what the people here are saying is that the way to set this definite rule is to look at what the industry has always done; that if you suddenly change the rule, you will greatly disrupt the way business is handled. You will probably for a period of time reduce the amount of this kind of business and have some short-term impact on the revenue which is not reflected in the staff revenue estimates because they try to estimate what would happen if things always went along as they are without any secondary effects.

I think there would be a substantial secondary effect by simply disrupting the practice that people have regularly been in. And apart from that, as I say, as long as you have a definite rule, it does not really make so much difference, by and large. As has been pointed out, if the supplier of the automobile takes the depreciation, the basis for that depreciation and credit will be lower than if the user takes it. That is why in the long run we think there is some net revenue gain. In the short run there is a slight revenue loss to the Government because you have people working under contracts that were formulated before the rules were changed. Once they have time to adapt themselves to the rules this will not happen any more.

On the point about the interest that the chairman just referred to, I think the important thing is when you look at the interest deduction taken by the seller, this is really a wash, because the user of the car pays the supplier of the car for the interest that the supplier pays on to the bank, so ultimately the user of the car pays the interest, the supplier gets income to pay it to the bank, and his deduction really does not count.

Under the present rule the user of the car, Mr. Gibbons, in your case, who has to pay the lessor enough to cover that interest does not get a deduction for that component of his payment. If he were called the owner of the car, without changing the amount he pays he would still pay the equivalent of the interest. It would suddenly become deductible, and there would be a net loss in that transaction offsetting the difference in the depreciation and the investment credit.

Thank you.

[The prepared statement follows:]

STATEMENT OF GERARD M. BRANNON, PH. D., ECONOMIC CONSULTANT TO AD HOC TAX GROUP OF U.S. MOTOR VEHICLE LESSORS, MANUFACTURERS, WORKERS, DEALERS, AND CONSUMERS

SUMMARY

1. It is concluded that the enactment of H.R. 1607 would have a negligible revenue effect.
2. In the short run, it seems very clear that the Treasury regulation which would be forestalled by H.R. 1607 would disrupt business practice and thereby reduce GNP and Treasury revenues. Even an average one month delay in the delivery of leased cars could generate a decline in GNP of about $1.2 billion and a revenue loss of $300 million.
3. In the long run, it seems clear that a major result of this Treasury regulation would be the increased use of a technically less efficient contract form. This involves some economic waste.
4. It is difficult to understand what social benefits Treasury could achieve by the regulation.

STATEMENT

I am Gerard M. Brannon. I have been retained by the law firm of Piper & Marbury in behalf of a number of motor vehicle lessors to provide revenue estimates and related economic analysis of changing the treatment of certain arrangements called "TRAC leases", for tax purposes from leases to conditional sales. This is the change that would be foreclosed by H.R. 1607. In this project, I have worked with Emil Sunley who agrees with the testimony that I shall give.

Both Sunley and I have been involved in the tax legislative process, and in the revenue estimating process, from the government side. Each of us was at one time in charge of the economic analysis staff that reports to the Assistant Secretary of the Treasury for Tax Policy. A brief biography is attached.

This personal background is relevant because before I get into detailed analysis of the revenue forecast, I want to offer an overall assessment of the revenue and economic issues which can be summarized in 5 points:

(1) In the long run, depending on some very fine details, there could be some small revenue gains or losses to the Treasury. I think that on balance, passage of the bill would be a slight revenue gain to the Treasury and this is the Joint Committee staff estimate.

(2) In the short run, it seems very clear that the Treasury regulation which would be forestalled by H.R. 1607 would disrupt business practice and thereby reduce GNP and Treasury revenues.

(3) In the long run, a major result of this Treasury regulation would be the increased use of a technically less efficient contract form. This involves some economic waste.

To my mind, these three points make an overwhelming case for the legislation. I am at a loss to understand what social benefit Treasury could achieve by defeating this legislation and ruling against present treatment of TRAC leases. I do want to call your attention to a small revenue loss that the Staff estimate shows for fiscal year 1984 and fiscal year 1985. It should be obvious that these are transitional losses that would arise if the Treasury applied an anti-TRAC regulation to pre-existing contracts which were written on the presumption that present practice would continue. For one thing, I doubt that Treasury would in fact rule in this retroactive fashion. For another, I don't think this is the right way to raise revenue, and Treasury should be foreclosed from doing it.

The reasoning behind these judgments is that what is mainly involved in this matter is which of two taxpayers gets the depreciation deduction and the investment credit. You should recall that only two years ago it was the policy decision of this Congress that there would be a net economic gain to the country if business taxpayers were given a completely unrestricted opportunity to sell depreciation deductions. That decision about safe harbor leasing was partly reversed last year but it was a close call.

What we have in the present issue is, in probably 95 percent or more of the cases, a matter of upsetting well-established business practices to no avail because the user will get the same benefit from tax depreciation that the provider got. There is some revenue loss and inefficiency in messing around this way. In some tiny minority of cases, you may get the result that some extra deductions are pushed to where they do no good. This is what you didn't want to happen in 1981 and what you were uncertain about in 1982. Whether it happens or not in a few cases is no excuse for upsetting a well-established practice.

It is not my purpose to develop at length the reasons for or against H.R. 1607, but I did want to present this overview of the kind of legislative question that is at issue. It is necessary, so to speak, to put you into the mood to consider the trivia involved in the revenue estimate.

(1) Directly, H.R. 1607 forecloses a possible Treasury regulation that may or may not be upheld in the Courts. If the Treasury regulation were contested and defeated, the legislation would have a net gain by foreclosing much fruitless litigation.

(2) Let us assume that without the legislation, a Treasury regulation would have stood up in the courts. All that the regulation does is to provide that a particular form of contract produces depreciation in the hands of the motor vehicle user rather than the motor vehicle provider. Providers could change the contract form, at some real loss of efficiency, or they could go along with the change in situs of the depreciation deduction, with little change in the contract form, other than changing prices.

I limit my economic analysis to the assumption that the Treasury regulation would stand up, so I will comment on the two forms of response.

First, in the short run, both of these changes are disruptive. A change in the situs of depreciation requires a change in the price. When the vehicle provider gets the accelerated depreciation, he is willing to take a lower price. If the special tax advantage moves to the vehicle user, the provider will have to raise the price to get in direct payments what he could have gotten in tax benefits. Literally, this change in situs involves the car user becoming an investor and may result in running car purchases through the capital budget process where previously a car lease was a routine outlay. In any case, vehicle users will have to go through some coordination with their accounting and tax departments to consider the tax value of depreciation to them and to compare it to the rental increase. All of this could occur when there is uncertainty about how the new regulation will stand up in Court.

A change in the contract form is also disruptive in ways that are fairly obvious. The TRAC lease form was invented to deal with a complex problem, how to assure that the lessor of vehicles would not lose as a result of inadequate maintenance programs by the users. Settling on a less satisfactory alternative, such as closed-end leases with "wear and tear" clauses, involves resetting prices.

Even an average one-month delay in the delivery of leased cars could generate a decline in GNP of about $1.2 billion and a revenue loss to $300 million.

In the long run, the pricing change involves a subtle source of revenue loss to the Treasury because the vehicle user must now compensate the provider through larger payments for the tax advantage of depreciation. This means that the basis of the vehicle is larger, which increases the amount subject to investment credit and accelerated depreciation. Reasonable calculations suggest that this effect could generate a revenue loss to the Treasury of $50 million a year.

In the long run, a pricing change could lead to some loss of depreciation deductions because some of the lessors of motor vehicles should be exempt organizations that could not use the depreciation deduction. For these cases, we would expect that most often the provider of the vehicles would use a contract form which allowed the depreciation deduction to stay with the provider.

To the extent that motor vehicles arre leased long-term for personal use, two scenarios are possible. One is, as we assumed above, that the contract form would be changed. I understand that a very small (under 5 percent) portion of long-term vehicle leases are for personal, non-business use, and in these cases a TRAC lease is unlikely. Thus, a convenient forecast is that lessors would uniformly switch to closed-end leases with no revenue effect.

The other possibility is that the depreciation and investment credit would be lost as the car user becomes "owner". But the car user now qualifies for an interest deduction. The net impact of all this is a potful of pluses and minuses:

(1) The provider loses accelerated depreciation worth about $400, and an investment credit worth about $400;

(2) the provider must raise the price about $1,330 (if he is in 40 percent bracket) to be able to pay $530 of tax and have $800 net to offset the above losses;

(3) If users continue to lease cars despite the price increase, they would become eligible for an interest deduction costing the government about $1,200 (assuming 35 percent marginal rate of tax and a 12 percent stated interest rate);

(4) To the extent that users keep on leasing government gains on balance ($530 plus $800, or $1,330 from providers while giving up only $1,200 to users);

(5) To the extent users switch to outright purchase, the government gain is only $800 and the loss about $1,000.

In all this I have made a bushelful of assumptions that could be changed. My guess is that you come out that Treasury wins some and loses some and the whole thing adds up to a fat zero.

In summary, we have attached a short table covering the revenue effects under different guesses about the future.

In the short run, H.R. 1607, produces a revenue gain for the Treasurey, either by foreclosing litigation over the regulation or by avoiding the disruption of business practice that adapting to the new rules would entail.

In the long run, the uncertainty is whether business would have adjusted to the regulation by changing the contract form involves some loss of efficiency and some loss of real income in the society and the real value of Treasury tax collections must be lower if the regulation goes into effect (H.R. 1607 thus produces a gain). Letting depreciation go over to the user would result in the loss of depreciation in some cases so the regulation would produce a revenue gain (and H.R. 1607 would mean a loss to Treasury). In the likely development, some of each response, the net revenue effect would be negligible.

By retroactively applying a new regulatory position the Treasury could gain something. This assumes that it would be "successful" in finding autos leased for personal use on audit and collecting the tax and that not many of the users would obtain refunds based on interest deduction. This is an abuse of Treasury power because these transactions would not have been carried out at the historical prices if the lessors had understood the new rules.

REVENUE CHANGE FROM H.R. 1607 UNDER ALTERNATIVE SCENARIOS

Scenario	Revenue effect on Treasury	
	Short run	Long run
Treasury loss litigation on regulation	Gain	0
Providers change contract form to closed end—prospective	Gain	Gain.
Providers change depreciation situs except where user is nontaxable—prospective	Gain	Negligible.
Providers change depreciation situs in all cases—prospective	Gain	Loss.
Retroactive application	loss	Irrelevant.

Chairman STARK. Mr. Sunley.

Mr. SUNLEY. Thank you, Mr. Chairman.

I have a prepared statement which I would like to submit for the record, but at this time I would like to respond to one of the issues that you raised, namely, consumer leases.

As you know, that is one of the new features of H.R. 1607 compared to section 210 of last year's legislation. Consider two alternatives: One, that we have a lease from a leasing company to a consumer who is not a business. As you have pointed out, in that situation you will have an investment tax credit and, of course, accelerated tax depreciation. The whole issue last year before the committee was how much was all that worth, and it was concluded that what you did in 1981 was somewhat better than expensing, and as a result, a half-basis adjustment was provided for the investment tax credit to cut back the tax benefits so that they were just equal to expensing.

It was pointed out to the committee a number of times, and I believe generally understood, that expensing was equivalent to having a zero tax rate on the normal return on an investment. And the reason for that is that if you have expensing—that is say you have tax savings worth 46 percent of the initial value of the asset—and that will turn out to be just equal to the present value of the taxes on the future income stream. So in present value terms, if you provide expensing or something equivalent to expensing, there is no net taxes on the income stream from that capital asset.

On the other hand, if the automobile is purchased outright by a consumer, it is true that there is no investment tax credit and no accelerated depreciation. On the other hand, consumer durables such as automobiles are treated the same as owner-occupied housing. The owner is not required to impute any income to himself, and the income from the ownership of that physical capital is not included in the tax base of the income tax system. So, again, the effective tax rate on the income from the ownership of the automobile is zero, the same as if we had a lease.

One might then ask well, what happens if there is debt financing, and I say that does not really matter, because if you own the car outright, then the consumer is able to deduct interest. If the car is purchased by a leasing company and then leased to a consumer, the leasing company claims an interest deduction, so the interest deduction is going to be claimed regardless of whether we have a lease or an outright sale.

Chairman STARK. Mr. Sunley, could you run through some numbers with me? If we have a $15,000 automobile, and let us assume that it cost the same to a leasing company as an aggressive nonbusiness shopper, so both people have a basis of $15,000 in the car. And if it is a nonbusiness personal use person, and I would say everyone pays 10 percent interest in my mythical world, all I get to deduct my first year is $1,500 as an individual, is that correct?

Mr. SUNLEY. Yes.

Chairman STARK. The leasing company, however, gets an investment tax credit of $1,500, is that correct?

Mr. SUNLEY. No. Six percent.

Chairman STARK. Six percent? All right. So it gets $900. And it gets to expense $5,000.

Mr. SUNLEY. Yes.

Chairman STARK. And it gets the same interest at $1,500 for $7,400 of writeoff in the first year, is that correct?

Mr. SUNLEY. Yes.

Chairman STARK. Assuming there is some income to write that off against, I see the Treasury getting $7,400. Well, investment tax credit is worth double basically because it is a credit, so you really ought to add another $900 to keep it comparable, so it is $8,300 of writeoff in the hands of the leasing company as opposed to only $1,500 in the individual purchaser.

Now, could you explain to me how the Treasury makes money that way, Mr. Sunley, in that particular transaction?

Mr. **Sunley**. In that first year there would be some gross rental income which would not be deductible by the consumer but would be included in gross income by the leasing company, which is a big piece of the story.

Chairman **Stark**. Well, you can guess how much, but it would have to be an awful lot of income to eat up that $8,300. Do you mean the guy is paying $8,300 in lease payments for a $15,000 car?

Mr. **Sunley**. No. I would say the first year there would indeed be some difference, and I think the Joint Committee recognized there might be some timing differences, but in present value terms it washes out.

Chairman **Stark**. Could you prepare for the committee the most micro of microeconomics to show me how the Treasury makes money in that kind of a comparison? I admit to not having the sophistication of all of these Ph. D.'s in economics here, but it is still pretty tough for me to balance off $8,300 worth of deductions as against $1,500, and tell me that the Treasury makes money—and maybe when you all were at the Treasury that is why we have the deficits we have.

Mr. **Sunley**. When I left the Treasury the deficit was well under $100 billion.

Mr. Chairman, let me just elaborate briefly here, and I would be glad to submit something for the record.

Let me see if I can get some understanding of what is going on with the issue of expensing. Suppose we were in a world with no taxes, and you are willing to purchase an automobile for $15,000 and lease it to me, and you charge a rent such that you earn a 10-percent rate of return on the amount of money you have at risk. That is what you require.

Now, we come along and introduce an income tax—let us say a 40-percent income tax for this example—and permit you to expense the asset so the first year you purchased this $15,000 car, and you write it off, and you receive a tax savings of 40 percent of $15,000 or $6,000.

Now, on the other hand, having written the car completely off the first year, you have no depreciation deductions in the second, third, fourth, and fifth years. But we know that the present value of that income stream has to be $15,000 at a 10-percent discount rate, and every dollar is subject to tax. Therefore, your rental stream being fully taxed is also reduced by 40 percent; and therefore, there is a reduction of $6,000, and your after-tax rental stream is $9,000, which is just equal to the amount of money you have at risk the first year having expensed the asset. So your after-tax rate of return on that investment when you have expensing is still 10 percent, which is just equal to the before-tax rate of return that we assumed, and in that sense we say there is a zero effective tax rate.

The present value of the taxes in the future on the income stream, $6,000, is just equal to the tax savings from expensing the asset the first year. And if you will look at the material prepared by the joint committee, the material prepared by the Council of Economic Advisers describing TEFRA, they show how the effective tax rate on new machinery and equipment under our new accelerated cost recovery system is indeed zero.

Chairman **Stark**. I was just doing the last 2 years of this. I look at the leasing company getting to deduct about $17,300 on a $15,000 car over 3 years, and all I get to deduct as an owner is $4,500. And you are still having a little trouble convincing me that the Treasury is making more on that transaction.

I can see some validity if you are talking about two business users there. If I were a business user taking the investment tax credit, paying the interest, you are probably walking out the same door you have come in, but you are basically creating an investment tax credit and rapid depreciation where it otherwise would not exist when you lease to a business user as opposed to a nonbusiness user.

Mr. **Sunley**. Someone will take an interest deduction. Interest is not really at issue. If I buy the car, I will write off $1,500 a year. If the leasing company buys it, they write off $1,500 a year.

Chairman **Stark**. I will buy that.

Mr. **Sunley**. So it seems to me we do not need to worry about the interest deduction. We now really only have to focus on what is left in the picture. And as I say, if I buy the car outright, I have some capital which is truly a part of the capital stock of the country and which ought to have imputed income.

Chairman **Stark**. But if I buy it, I give up some savings.

Mr. **Sunley**. If I buy a car outright, I take $15,000 out of the bank and put it into an automobile, and the imputed income of that automobile is not subject to tax. There is a zero tax rate on the automobile. Whereas if I had left the money in the bank, there would be tax on the income.

Chairman **Stark**. But if I take the same money out of the bank and lend it to the leasing company, it is the same thing. What you keep ignoring is that we are creating investment tax credit and rapid depreciation where it otherwise would not exist. And I do not see how that benefits the Treasury.

Mr. **Sunley**. I am not saying it benefits the Treasury. I said it does not hurt the Treasury.

Chairman **Stark**. Well, I am one who happens to believe that every investment tax credit that is available creates a loss of revenue. No one has ever told me it creates any revenue, and I do not think I have ever seen any.

[The prepared statement of Emil Sunley follows:]

STATEMENT OF EMIL M. SUNLEY, ECONOMIC CONSULTANT TO AD HOC TAX GROUP OF U.S. MOTOR VEHICLE LESSORS, LESSEES, DEALERS, MANUFACTURERS, WORKERS, AND USERS

SUMMARY

1. Treasury's proposed regulations on TRAC Leases if adopted as a final rule would cause serious disruptions, both short term and long term, in the automobile leasing and sales markets.

2. In the short-run it is reasonable to assume that a loss in automobile sales translates dollar-for-dollar into a loss of GNP. Thus a loss in automobile sales reduces government revenue. Using the usual Treasury assumption of a 24 percent tax rate on changes in GNP, a one month delay would reduce Federal revenues by $300 million and a three month delay would reduce Federal revenues by $900 million.

3. In the long term, if the Treasury regulations are adopted, businesses may continue to lease automobiles but under closed-end leases, businesses may purchase automobiles outright instead of leasing them, or businesses may continue to use TRAC leases but rents would be adjusted upward to reflect the fact that the trans-

action would be treated as a conditional sale for tax purposes. Those three alternatives would have different economic effects on the economy and the leasing industry and would have different impacts on federal revenues. No one can predict just how the leasing industry would adapt. If most lessors transfer the depreciation deductions and the investment tax credit—the conditional sale alternative—there could even be a long-term revenue loss to the Treasury.

4. Leasing of personal automobiles does not involve a revenue loss for the Government. The effective tax rate on the income is zero whether the automobile is leased or owned outright.

STATEMENT

I am Emil M. Sunley, Director of Tax Analysis in the National Affairs Office of Deloitte Haskins & Sells, an international accounting firm. I am submitting this statement to you in my capacity as an economic consultant engaged by the law firm of Piper & Marbury on behalf of an ad hoc group of U.S. motor vehicles lessors, lessees, manufacturers, workers, and dealers, on the economic and revenue impact of H.R. 1607 regarding federal tax treatment of TRAC leases.

A lease with a terminal rental adjustment clause (TRAC) is a common form of a motor vehicle lease. In 1981, approximately 4 million vehicles were leased under TRAC leases which allow a rental adjustment at the end of the lease based on the amount realized when the lessor sells the leased vechicle. H.R. 1607 will make clear that a terminal rental adjustment clause shall not be taken into account in determining whether a motor vehicle operating lease is a lease for federal tax purposes.

Section 210 of the Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA) provided that a terminal rental adjustment clause should not be taken into account in determining whether a lease for business use is a lease for federal tax purposes. H.R. 1607 would codify the rule of section 210, extend it to consumer leases, and withdraw the restricted power it granted to Treasury to change the rule prospectively by regulation. Treasury, however, has issued proposed regulations reversing the rule of section 210.

Today I want to focus on the economic effects and revenue impact of H.R. 1607. In the case of business leases, there would be no economic effect or revenue impact unless Treasury issues final regulations denying lease treatment for TRAC leases. The question, therefore, becomes what would be the economic effects and revenue impact of the proposed Treasury regulations if Senate H.R. 1607 were not enacted into law.

Treasury's proposed regulations on TRAC leases if adopted as a final rule would cause serious disruptions, both short term and long term, in the automobile leasing and sales markets.

H.R. 1607, if enacted, would not have a significant impact on Federal revenues. In fact, the Joint Committee on Taxation has estimated that H.R. 1607 would result in a revenue gain of $91 million over a five-year period. The Treasury Department does not appear to be in disagreement with this estimate. In testimony on S. 1161, the Senate version of H.R. 1607, the Treasury Department indicated that, "We agree that the issues in S. 1161 should not be settled on the basis of revenue estimates."

Short-term disruption

If the Treasury regulation is adopted, effective the date of publication, there will clearly be a significant short term disruption. Contracts would have to be rewritten. Executives within each company would have to consider the new terms and conditions. The path of least resistance for many business vehicle users would be not to take delivery of new automobiles in the interim. Instead these companies would continue to use the automobiles previously leased.

There is probably no way to get a good handle on just how long the short run disruption might last. Given normal "bureaucratic" delays in large organizations, the short term disruption would likely last at least three months. The delay could last as long as six to nine months. Each month delay in replacing leased vehicles would result in a loss of 125,000 new car purchases, having a sales value of $1.2 billion. (This assumes that 3.5 million cars are currently leased to businesses under TRAC leases and that these leased cars turn over on average every 28 months.) A three-month delay would result in a loss of 375,000 new car purchases, with a sales value of $3.7 billion.

In the short-run it is reasonable to assume that a loss in automobile sales translates dollar-for-dollar into a loss of GNP. Thus a loss in automobile sales reduces government revenue. Using the usual Treasury assumption of a 24 percent tax rate on changes in GNP, a one month delay would reduce Federal revenues by $300 million and a three month delay would reduce Federal revenues by $900 million.

Long-term disruption

In the long term, elimination of TRAC leases would raise the cost of automobiles for business use. Given the higher cost, businesses will use fewer automobiles. How many fewer depends on: (1) the percentage increase in the after-tax cost of using an automobile and (2) how sensitive the demand for automobiles is to an increase in cost. This second factor is usually referred to as the elasticity of demand and is defined as the percentage decrease in demand for a given percentage increase in price. A reasonable estimate of the elasticity of demand for automobiles probably would be 1.0. Given this estimate of elasticity of demand, a 10 percent increase in the cost of automobiles will reduce demand by 10 percent.

Three alternatives need to be considered. First, businesses may continue to lease automobiles, but under closed-end leases. Second, businesses may purchase automobiles outright instead of leasing them. Third, TRAC leases may continue to be used, but rents would be adjusted upward to reflect the fact that the transaction will be treated as a conditional sale for tax purposes under which the lessee/buyer would be allowed the depreciation deductions and investment tax credits.

These three alternatives would have different economic effects on the economy and the leasing industry and would have different impacts on federal revenues. No one at this time can predict just how the leasing industry would adapt if the proposed regulations were issued in final form. A complete analysis of the economic and tax consequences of the proposed regulations would have to consider all three alternatives.

1. Closed-end lease alternative.—If businesses switch to closed-end leases, the rentals will have to be higher because the lessor must calculate rentals by reference to estimated rather than actual residuals. A number of leasing companies offer both closed-end and TRAC leases. One company reviewed actual leases for a 1980 model sold in 1982 and a 1979 model sold in 1981. In case of the 1980 model, the closed-end depreciation cost that was built into the lease rate for a closed-end lease was $3,310. When the automobile was sold in 1982 it turned out the actual net depreciation cost was only $2,515. Thus, on the 1980 model a closed-end lease customer would have paid $795 ($3,310 − $2,515) per car more than a TRAC customer. The spread was only $225 for the 1979 model sold in 1981. This resulted from the weak resale market experienced in 1981.

It should be recognized that closed-end leases have terminal adjustments; namely, "wear and tear" clauses. These clauses protect the lessor from the risk that cars will be returned in poor condition. In theory, they do not protect the lessor from fluctuations in the condition of the resale market. In practice, however, these clauses may provide some protection. When the resale market is strong, lessors may be quite lenient in assessing charges for "wear and tear". But, when the resale market is soft, lessors may fully enforce "wear and tear" clauses.

2. Ownership Alternative.—Businesses will lease or buy equipment, including automobiles, depending on which procedure minimizes the cost to capital. Even in a world without taxes, businesses would lease equipment when the cost is less than outright purchase. There are essentially four reasons why leasing an automobile may be less costly to users than outright purchase.

The lessor may purchase automobiles in volume at a lower price per vehicle.

The lessor may be able to sell the automobiles at the end of the lease term at higher prices than the users would be able to sell them.

The lessor may be able to finance the equipment on more favorable credit terms.

The lessor may be able to more efficiently manage a stock of automobiles than the user. For example, the lessor may be able more efficiently to title and insure automobiles.

To the extent that the cost of ownership is higher than the cost of leasing, businesses will use fewer automobiles. How many fewer, as indicated above, depends on the elasticity of demand.

There is also an additional effect of switching to ownership. The average holding period for fleet users who own their own fleets is 32 months as compared to an average holding period of 28 months for fleet users who lease their business fleets. Given that 4 million cars and light trucks are under TRAC leases, a lengthening of the average holding period from 28 to 32 months would reduce the annual turnover of leased vehicles by 200,000 units. This translates into a $2 billion annual reduction in new car purchases for business use.

3. Transfer Depreciation Deduction.—The third alternative would be to continue to use the TRAC lease but to treat the transaction as a conditional sale for tax purposes. The lessor/seller would have to raise the rentals (or "installment sales payments") to offset the reduced tax shield. The lessee/buyer would claim depreciation deductions and also deduct unstated interest on the "installment sale."

It turns out that this alternative would actually lower the after-tax cost of the lessee/buyer. (This is demonstrated by an example below.) However, a switch to conditional sales still could be disruptive. If the users are treated for tax purposes as purchasers, then the decision to "lease" another automobile would be treated in many firms as a capital budgeting decision. In contrast, under current business practices, replacing leased automobiles is treated as an operating cost.

A switch from a lease to a conditional sale transfers the depreciation deductions to the lessee/buyer. But since the buyer will have a higher cost basis, the amount of depreciation and investment tax credit allowed is increased. The after-tax cost of the lessee/buyer is reduced. The Government comes out behind.

Consider a simplified TRAC lease of a $10,000 automobile with the following terms and conditions:[1]

1. The lease is for 30 months with rental payments of $1,665 at the beginning of each 6 month period.
2. The automobile is placed in service on July 1, 1983.
3. The lessor and the lessee are calendar year taxpayers.
4. The lessor elects to pass through the investment tax credit.
5. The automobile is depreciated as 3-year property.
6. The automobile is turned in and sold on December 31, 1985.
7. The automobile depreciates in value at the rate of 1.8 percent of original cost per month. After 30 months, the automobile is sold for $4,600.
8. The terminal rental adjustment clause assumes that the automobile is sold for $4,600.

If the lessor uses a 12 percent after-tax discount rate, the present value of the after-tax cash flow is just equal to the original investment of $10,000.

The cash-flow from the investment is calculated as shown in Table 1. The addendum to Table 1 indicates the present value of the taxes paid by the lessor is $921.

Now consider a conditional sale. The rentals (or installment payments) are increased by 3.6 percent from $1,665 to $1,725, as shown in Table 2. The present value of the after-tax cash-flow of the lessor/seller is still equal to $10,000. He is just as well off.

Tables 3 and 4 show the after-tax cost of the lessee/buyer. Under a TRAC lease, the present value of the after-tax cost is $3,953 (Table 3), but if there is a conditional sale (Table 4), the present values of the after-tax cost is reduced to $3,902.

How does the Government come out? Under a conditional sale, the Government loses $50 per automobile. Given that 1.7 million cars and light trucks are leased each year, if all TRAC leases are switched to conditional sales, the annual revenue loss would be $85 million.

	Present value of taxes
Lease transaction:	
Lessor	$921
Lessee	−3,504
Total	−2,583
Conditional sale:	
Seller	1,190
Buyer	−3,823
Total	−2,633
Difference	−50

Consumer leases

Section 210 of the Tax Equity and Fiscal Responsibility Act of 1982 provides an interim solution to the problem of how leases of automobiles with terminal rental adjustment clauses should be treated for tax purposes. It only applies to leases in which the lessee uses the vehicle for business, as opposed to personal, purposes. H.R. 1607, however, is broader than section 210 in that it covers leases for personal use in addition to leases for business use.

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[1] This admittedly is a simplified example. Rental payments are typically made monthly. The rents charged also must cover the services such as insurance and titling provided by the lessor. All equity financing is assumed. The example, however, captures the essence of the tax issues.

Should Treasury be concerned with the leasing of automobiles for personal use? What is the revenue impact of including leases for personal use?

There are no tax advantages for leasing for personal use. The income tax on the income stream from the automobile is zero whether the car is owned outright or leased. If the automobile is owned outright, the imputed income from the ownership of the automobile is not taxed. Put another way, the owner is not required to include in taxable income the imputed return on the capital invested in the automobile.

If, instead, the automobile is leased, the tax law provides capital recovery allowances—depreciation deductions and the investment tax credit—that are eqivalent to expensing; that is, the rules for capital recovery provide the same present value of tax savings as would be provided if the taxpayer were permitted to fully deduct the cost of the investment when it is placed in service. Inasmuch as expensing is equivalent to a zero tax rate on the income from depreciable capital, the effective tax rate on the lessor is zero, the same as the effective tax on an owner/user.

The assumption of debt financing does not change the conclusion that there are no tax advantages for leasing automobiles for personal use. Given debt financing, either the lessee/owner or the lessor will get the interest deduction. The tax savings from the interest deduction will be essentially the same because the top bracket tax rate for individuals is about the same as that for corporations.

Leasing of personal automobiles does not involve a revenue loss for the Government. As explained above, the effective tax rate on the income is zero whether the automobile is leased or owned outright.

CONCLUSION

H.R. 1607 will make clear that a terminal rental adjustment clause shall not be taken into account in determining whether a motor vehicle operating lease is a lease for federal tax purposes. It simply codifies the rule provided in TEFRA and insures that traditional practices in the motor vehicle leasing industry—practices that predate enactment of the investment tax credit and acceleration of tax depreciation—continue unless changed by Congress in the future. If H.R. 1607 is not enacted and Treasury issues the proposed regulations in final form, there would be serious short run and long run disruptions to the automobile leasing industry. Assuming most lessors continue to use TRAC leases but treat them as conditional sales, there could even be a long-term revenue loss to the Treasury. One can only wonder what tax policy objectives would be served by forcing the automobile leasing industry to alter its traditional way of doing business.

TABLE 1.—LEASE EXAMPLE CALCULATION OF PRESENT VALUE OF LESSOR'S CASH FLOW

Time and item	Amount	Discount factor	Present value of cash flow
July 1, 1983—Rent	$1,665	1.00000	$1,665
Dec. 31, 1983—Tax at end of 1983:			
Rent	1,665		
Depreciation	−2,500		
Taxable income	−835		
Tax (46 percent)	−384		
Cash flow	384	.94491	363
Jan. 1, 1984—Rent	1,665	.94491	1,573
July 1, 1984—Rent	1,665	.89286	1,487
Dec. 31, 1984—Tax at end of 1984:			
Rent	3,330		
Depreciation	−3,800		
Taxable income	−470		
Tax (46 percent)	−216		
Cash flow	216	.84367	182
Jan. 1, 1985—Rent	1,665	.84367	1,405
July 1, 1985—Rent	1,665	.79719	1,327
Dec. 31, 1985—Regular tax at end of 1985:			
Rent	3,330		
Tax (46 percent)	1,532		

TABLE 1.—LEASE EXAMPLE CALCULATION OF PRESENT VALUE OF LESSOR'S CASH FLOW—Continued

Time and item	Amount	Discount factor	Present value of cash flow
Cash flow	−1,532	.75328	−1,154
Dec. 31, 1985—Proceeds from sale	4,600	.75328	3,465
Recapture tax:			
Sales price	4,600		
Adjusted basis	3,700		
Gain	900		
Tax (46 percent)	414		
Cash flow	−414	.75328	−312
			10,000
Addendum:			
Present value of tax payments:			
Dec. 31, 1983			−363
Dec. 31, 1984			−182
Dec. 31, 1985			1,154
Dec. 31, 1985			312
Total			921

TABLE 2.—CONDITIONAL-SALE EXAMPLE CALCULATION OF PRESENT VALUE OF THE SELLER'S CASH FLOW

Time and item	Amount	Discount factor	Present value of cash flow
July 1, 1983—Payment	$1,725	1.00000	$1,725
Dec. 31, 1983—Tax at end of 1983:			
Payment	1,725		
Cost recovery[1]	1,304		
Taxable income	421		
Tax (46 percent)	194		
Cash flow	−194	.94491	−183
Jan. 1, 1984—Payment	1,725	.94491	1,630
July 1, 1984—Payment	1,725	.89286	1,540
Dec. 31, 1984—Tax at end of 1984:			
Payments	3,450		
Cost recovery	2,609		
Taxable income	841		
Tax (46 percent)	387		
Cash flow	−387	.84367	−327
Jan. 1, 1985—Payment	1,725	.84367	1,455
July 1, 1985—Payment	1,725	.79719	1,375
Dec. 31, 1985—Final Payment	4,600	.75328	3,465
Dec. 31, 1985—Tax at end of 1985:			
Payment	8,050		
Cost recovery	6,087		
Taxable income	1,963		
Tax (46 percent)	903		
Cash flow	−903	.75328	−680
			10,000
Addendum:			
Present value of tax payments:			
Dec. 31, 1983			183
Dec. 31, 1984			327

TABLE 2.—CONDITIONAL-SALE EXAMPLE CALCULATION OF PRESENT VALUE OF THE SELLER'S CASH FLOW—Continued

Time and item	Amount	Discount factor	Present value of cash flow
Dec. 31, 1985			680
Total			1,190

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[1] The original cost of $10,000 is recovered ratably as the five installments of $1,725 and the final installment of $4,600 are received. Cost recovery is equal to 75.614 percent of each payment.

TABLE 3.—LEASE EXAMPLE CALCULATION OF THE LESSEE'S AFTER-TAX COST

Time and item	Amount	Discount factor	Present value of cash flow
July 1, 1983—Payment	$1,665	1.00000	$1,665
Dec. 31, 1983—Tax at end of 1983:			
Rent	−1,665		
One-third of basis adjustment	100		
Taxable income	−1,565		
Tax (46 percent)	−720		
ITC	−600		
Tax	−1,320	.94491	−1,247
Jan. 1, 1984—Rent	1,665	.94491	1,573
July 1, 1984—Rent	1,665	.89286	1,487
Dec. 31, 1984—Tax at end of 1984:			
Rent	−3,330		
One-third of basis adjustment	100		
Taxable income	−3,230		
Tax (46 percent)	−1,486	.84367	−1,254
Jan. 1, 1985—Rent	1,665	.84367	1,405
July 1, 1985—Rent	1,665	.79719	1,327
Dec. 31, 1985—Tax at end of 1985:			
Rent	−3,330		
Taxable income	−3,330		
Tax (46 percent)	−1,532		
Recapture of ITC	200		
Tax	−1,332	.75328	−1,003
			3,953
Addendum:			
Present value of tax payments:			
Dec. 31, 1983			−1,247
Dec. 31, 1984			−1,254
Dec. 31, 1985			−1,003
Total			−3,504

TABLE 4.—CONDITIONAL-SALE EXAMPLE CALCULATION OF THE BUYER'S AFTER-TAX COST

Time and item	Amount	Discount factor	Present value of cash flow
July 1, 1983—Payment	$1,725	1.00000	$1,725
Dec. 31, 1983—Tax at end of 1983:			
Depreciation[1]	−2,796		
Taxable income	−2,796		
Tax (46 percent)	−1,286		

TABLE 4.—CONDITIONAL-SALE EXAMPLE CALCULATION OF THE BUYER'S AFTER-TAX COST—Cont.

Time and item	Amount	Discount factor	Present value of cash flow
ITC[1]	−692		
	−1,978	.94491	−1,869
Jan. 1, 1984—Payment	1,725	.94491	1,630
July 1, 1984—Payment	1,725	.89286	1,540
Dec. 31, 1984—Tax at end of 1984:			
Depreciation	−4,249		
Unstated interest[2]	−299		
Taxable income	−4,548		
Tax (46 percent)	−2,092	.84367	−1,765
Jan. 1, 1985—Payment	1,725	.84367	1,455
July 1, 1985—Payment	1,725	.79719	1,375
Dec. 31, 1985—Regular tax at end of 1985:			
Unstated interest	−1,398		
Taxable income	−1,398		
Tax (46 percent)	−643		
Recapture of ITC	231		
Tax	−412	.75328	−310
Dec. 31, 1985—Recapture tax:			
Sales price	4,600		
Adjusted basis[3]	4,252		
Gain	348		
Tax (46 percent)	160	.75328	121
			3,902
Addendum:			
Present value of tax payments:			
Dec. 31, 1983			−1,869
Dec. 31, 1984			−1,765
Dec. 31, 1985			−310
Dec. 31, 1985			121
Total			−3,823

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[1] The basis for depreciation and the ITC are determined under the rules for an installment sale using a 10 percent discount rate. The basis adjustment for one-half of the ITC reduces the basis for depreciation from $11,528 to $11,182.

Time	Payments	Discount factor	Present value
July 1, 1983	$1,725	1.00000	$1,725
Jan. 1, 1984	1,725	1.00000	1,725
July 1, 1984	1,725	.90703	1,565
Jan. 1, 1985	1,725	.86384	1,490
July 1, 1985	1,725	.82270	1,419
Dec. 31, 1985	4,600	.78353	3,604
Total	13,225		11,528
Times			.97
Total			11,182

[2] The amount of unstated interest on this installment purchase is $1,697, which is equal to the difference between payments of $13,225 and basis of $11,528. Therefore, 17.361 percent of the last four payments is treated as unstated interest and deducted for tax purposes.

[3] Adjusted basis at time of sale is equal to $4,252.

Original basis	$11,528
Less ITC basis adjustment	346
Total	11,182
Less prior depreciation	7,045
Total	4,137
Plus one-half of recaptured ITC	115
Adjusted basis	4,252

Mr. **Brannon**. May I comment on your difficulty there, Mr. Chairman?

Chairman **Stark**. Please.

Mr. **Brannon**. First, on the interest I want to disagree a bit with Emil. I think the interest does make a difference. Go to your case, a $15,000 car. In the first case where the supplier of the car was the owner, the supplier will have to pay interest to a bank, let us say $500 a year.

Chairman **Stark**. Let us say it is the same for both, $1,500, 10 percent on a $15,000 car.

Mr. **Brannon**. And he will have to add that to the payment the user of the car makes. The supplier is not in this for fun. He will get his cost covered. So when he does the borrowing, he will add to his income $1,500 a year and deduct it so that at that stage the interest is just washes out, and the user of the car is still paid the $1,500. He has added to what he has had to pay.

Chairman **Stark**. But the user of the car will lose income.

Mr. **Brannon**. Well, he is still paying that $1,500, but he gets no deduction for it. Now it just a part of this lease payment. If we call the user the owner of the car, the user now pays the same $1,500, but it goes directly to the bank. This does not change the supplier at all, because the supplier was previously getting $1,500 and cashing it out. Now, the user is getting an extra deduction that he did not have before, even though he is still paying the same $1,500.

Chairman **Stark**. But the Treasury is not getting beaten out of $5,000 of expense the first year, the rapid depreciation, and the investment tax credit.

Mr. **Brannon**. On the depreciation what is happening is if you treat the supplier as a seller, he subtracts his $1,500 cost from the payments. It will now be a cost of goods sold instead of depreciation, so he will basically subtract that $1,500 anyway. It might be in a little different year, and I have worked out an example of exactly that in my testimony. But that $1,500 will be subtracted.

By and large, the advantage of the interest deduction to the user just about offsets the speedup available in the depreciation, not the whole deduction.

Chairman **Stark**. And the $5,000 of expense and the investment tax credit?

Mr. **Brannon**. Well, he is going to deduct $1,500 anyway, either as cost of goods sold or depreciation.

Chairman **Stark**. But look at the $15,000.

Mr. **Brannon**. But the difference is some is deducted a little earlier.

Chairman **Stark**. There is $6,800 if you double the investment tax credit in the first year that would not otherwise exist if a nonbusiness owner bought the car.

Mr. **Brannon**. I thought we just agreed it was $900 investment tax credit.

Chairman **Stark**. I beg your pardon?

Mr. **Brannon**. $900.

Chairman **Stark**. But an investment tax credit is equivalent to $1,800 of deduction, so just to make it comparable, that is it.

Mr. **Brannon**. But this interest is a deduction that runs every year that the loan is outstanding. It is not a 1-year item.

Chairman **Stark**. Well, you get depreciation in the second year.

Mr. **Brannon**. But what is involved in the depreciation is the $1,500 will be subtracted sometime anyway. That is the cost of goods sold. And there is a slight difference in the depreciation as to when it is subtracted, but it is not an extra deduction.

Mr. **Gibbons**. Mr. Chairman, I came here to talk about the terminal rental adjustment charge. You do not like the investment credit. I do not think I have ever been caught voting for it. You can ask Eddie Cohen over here. I used to raise hell about it, when he was Assistant Secretary of Treasury for Tax Policy. I did not vote for it in the sixties. I did not vote for it in the seventies. I have not voted for it in the eighties that I can remember.

I do not like it. I think it is terrible. You feel the same way. That is not the issue here. We ought to get rid of it. You and I would get rid of it. We do not have enough votes.

Chairman **Stark**. If you are suggesting we amend this to take out the first year expensing, and the investment tax credit, you have got no quarrels with me.

Mr. **Gibbons**. If I could do it for everybody else, I do not have any objection to it. I just do not like to see these people treated that way. I am here to talk about the terminal rental adjustment charge. It makes good economic sense to give someone an encouragement not just for them and not just for the lessor and lessee but for all America, to give them some incentive to take care of the stuff.

Now, I rent a car because it is the convenient thing for me to do, not because it makes a hell of a lot of economic sense. But because of the crazy life we live, it is easier for me to rent a car than it is to own one and worry about the upkeep on it.

But I do do things. I rotate the tires. I would not do that if I were just leasing the thing and I could not get anything for having saved some money on the car. I keep it clean outside and inside. I do not drive it excessively fast because I am scared of getting caught, and I do not want to tear it up either. It is out of my pocketbook. And I treat it as if I really had a financial incentive to treat it a little better, because I know when I turn the car in at the end of the lease period I will get some advantage in my own pocket for having taken a little better care of the thing.

Now, that is good for America. We should not be encouraging people to tear up property. And I can agree with you on all of these arguments that you have about excessive depreciation, about excessive amounts of investment tax credit. But, hell, that is not what I came here to talk about. I came here to talk about the terminal rental adjustment charge, Mr. Chairman.

Chairman **Stark**. I have no quarrel with that. I just have a quarrel with creating investment tax credit, the first-year expensing and rapid depreciation where there is no business use. And if we could take care of that, I will join your bill.

Mr. **Gibbons**. You know, Pete, there are millions of cars sold every year, and not very many of them are leased. Leasing is not that attractive to most people. Most people do not lease cars for private use. I do, and perhaps other people do, because of the crazy life we live in this job. It is just a convenience to me. It is really kind of ridiculous to say it is not a part of my business expense, because I have to travel all over in the thing and get reimbursements back and forth and everything else.

But most people do not rent cars for personal use. I find around my own hometown most of them—frankly, if you want to get at all the sins committed around cars, you and I know that a lot of people charge to their business cars that are entirely personal use. I get so sick every time I see that. Every little—I should not say little—every successful business around my town has fleets of cars that the directors, officers, and employees, and wives, and daughters and husbands and everyone else are using as a business purpose, charging off the gasoline, the oil and everything else. The IRS never audits them.

There are a lot of rackets out there, but the terminal rental adjustment clause is not a racket. It makes good sense.

Chairman **Stark**. Are there any other witnesses on the panel who have statements?

Mr. **Penn**. Will it be all right for Mr. Wickham to make a statement? He is our counsel.

Mr. **Gibbons**. Excuse me. I have to go and dress someone else up. [Laughter.]

STATEMENT OF DALE W. WICKHAM, COUNSEL, AD HOC TAX GROUP OF MOTOR VEHICLE LESSORS, LESSEES, DEALERS, MANUFACTURERS, WORKERS AND USERS

Mr. **Wickham**. Mr. Chairman, I am Dale Wickham. I am here as counsel for the ad hoc group of representatives appearing before you in a panel. So as not to take further time of the committee by extended oral presentation today, I might, with the permission of the Chair, simply submit material in reply to each of the points made by the Treasury Department and that have been raised by some of the questions here which were made in opposition to H.R. 1607 so that the Chair and the other members——

Chairman **Stark**. If I could interrupt for 1 second, I have been informed by the Joint Committee that the personal use of these leases cost $100 million in lost revenue. If we can eliminate the investment tax credit, the first-year expensing and the rapid depreciation on those leases where there is no business user, we would pick up an additional $100 million. And the Chair would be happy to join in support of the bill.

Mr. **Sunley**. May I comment briefly? I believe that that is a little higher number than the Joint Committee originally had with respect to the consumer leases.

My understanding of their original number that they presented and that Mr. Brockway supplied to Senator Durenberger by a letter showed a fiscal year effect over 5 years of a gain of $91 million. The Joint Committee had a loss the first two fiscal years. But in speaking once with the staff, I was told that the whole loss was really the first calendar year. I asked what is going on here, and they said the biggest piece of the action really relates to the consumer leases. I asked well, how come, and they said it is the retroactive feature of the consumer leases. And I said what do you mean? I did not understand the issue really. And they said well, the IRS public position is these consumer leases, because they have a TRAC clause, are not really leases, so the IRS will go out and be setting up adjustments on leasing companies and denying the investment credit and depreciation deduction.

I said what then happens to the user in this situations? Well, no one had ever looked at the user. We are going to whipsaw. We will work on one side of the transaction, but we will not go back on the other side. That may indeed be a way IRS can make some money.

Chairman **Stark**. All I am suggesting is whatever it is, it sounds fair to me. I see no reason to create an investment tax credit and first year expensing where it does not otherwise exist. It seems to me it is a very simple amendment, and if the bill were to see the light of day, I would support that amendment to it.

Mr. **Sunley**. Mr. Stark, perhaps I should not suggest this to you, but if we had a closed end lease, you would get the investment credit if you leased to a consumer. No one is disputing that issue.

I think Sam is exactly right. The issue is whether a TRAC clause should be taken into account in determining whether this is a lease or not. And Sam's point is to say here, the IRS for some reason and some members of the Ways and Means staff are concerned that for some purity sense that this TRAC clause——

Chairman **Stark**. I am concerned.

Mr. **Sunley**. And you are concerned, and I respect that.

Chairman **Stark**. Which is much more important than whether the staff is concerned.

Mr. **Sunley**. I understand that, but I am saying whether or not a TRAC clause is present should not be determinative in whether this is a true lease or not.

Mr. **Wickham**. Mr. Chairman.

Chairman **Stark**. Proceed.

Mr. **Wickham**. This is Dale Wickham again. If I might just complete what I started to say. I would like, with your permission, to submit a response to each of the points made in opposition to H.R. 1607 by the Treasury Department, some of which have also been the subject of questions today, if that meets with your approval.

Chairman **Stark**. Without objection, certainly.

Mr. **Wickham**. And in addition, so far as the revenue estimates are concerned, we would like to submit for the record a letter of September 26, 1983, written by the chief of staff of the Joint Committee on Taxation to Senator Durenberger, the sponsor of the identical Senate bill, S. 1161, stating their estimates of the revenue effects of S. 1161 for each of the 5 fiscal years 1984 through 1988.

I should state that the materials we submit will address the question the chairman inquired about as to whether section 210 of TEFRA in fact applies to leases entered into after the date of its enactment, as well as to leases entered into before its enactment. We will address that in the materials submitted.

[The materials follow:]

STATEMENT OF DALE W. WICKHAM, COUNSEL, AD HOC TAX GROUP OF U.S. MOTOR VEHICLE LESSORS, LESSEES, DEALERS, MANUFACTUERS, WORKERS, AND USERS

RESPONSE TO TREASURY POINTS IN OPPOSITION TO H.R. 1607 (RELATING TO FEDERAL TAX TREATMENT OF OPEN-END MOTOR VEHICLE TRAC LEASES)

In my capacity as counsel to the ad hoc group of motor vehicle lessors, manufacturers, dealers, users and workers supporting prompt enactment of H.R. 1607, I appreciate the opportunity to respond for the record to several points in opposition to H.R. 1607 that were made by Mikel Rollyson on behalf of the Treasury Department at the public hearing held on November 3 by the House Ways and Means Committee's Subcommittee on Select Revenue Measures.

I shall focus here only on the 5 key points made on behalf of the Treasury Department that seem to us to be simply wrong or questionable as a matter of public policy.

In summary, those 5 points and our views on them are as follows:

First, Mr. Rollyson seemed at the hearing to take a position that depreciation tax deductions and investment tax credits ought to be denied to lessors of motor vehicles or other equipment when the lessee of the equipment uses it for personal purposes rather than in a trade or business.

It is a hardware store operator to be denied a depreciation deduction to recover his investment in power lawnmowers or other tools which he bought and financed with debt on which he is personally liable and which he is in the business of renting or leasing for home use because the customer uses the rented equipment for personal purposes? Is an amusement park operator to be denied a depreciation deduction to recover his investment in a ferris wheel which he bought and financed with debt on which he is personally liable because the customer uses the equipment purely for his personal pleasure? In each case the customer certainly is using the equipment for purely personal purposes, and may be assumed to be getting the use of it at a price that will be higher if the hardware store or amusement park-business operator is allowed no depreciation deduction; but is it really a Departmental view of the U.S. Treasury that either of those fact has any proper bearing on whether a taxpayer in the business of leasing or otherwise providing equipment for others' use is to be allowed a depreciation reduction to recover the cost of his investment in equipment needed to carry on his business. This seems to us to be indefensible as a matter of public tax policy, whether the point is made only as to leased motor vehicles or is applied generally to all leased property.

Second, Treasury's stated position that motor vehicle TRAC leases are conditional sales instead of true leases is wrong as a matter of non-tax law and unsound tax policy. That position relies on a discredited "benefits and burdens" test, long urged by certain IRS personnel, which directly conflicts with a statutorily enunciated policy of Congress as to "net leases." That policy recognizes a net lessor's entitlement to depreciation tax deductions even though the lessor "is either guaranteed a specified return or is guaranteed in whole or in part against loss of income" (IRC § 57(d)(1)(B)) via lease provisions shifting to the lessee a variety of cost burdens and risks connected with the leased property.

As a procedural matter, I submit that such a position ought not be allowed to be imposed as a new rule of tax law unless the IRS bears the burden of proving to the Congress that it would be good economic policy and good tax policy for the Congress to change the traditional tax treatment of net leases generally and of net operating motor vehicle TRAC leases in particular.

Third, the position taken is simply wrong in stating that the rule of law proposed in H.R. 1607 is a "guarantee of lease treatment" amounting to restoration for this one exceptional case of "safe harbor" leasing rule that was enacted in 1981 and repealed in 1982. The bill, like section 210 of TEFRA, does not "guarantee lease treatment" of TRAC leases; it prevents a TRAC clause from denying lease treatment but the lease must meet all requirements of law for qualification as a true lease.

Fourth, it again is simply wrong to imply that the presence of a TRAC clasuse in an open-end motor vehicle operating lease does not lower the cost to the user of renting the property.

Fifth, it also is wrong to state that lease treatment for federal tax purposes of open-end motor vehicle TRAC lease agreements is not-long established and was not tacitly approved by the IRS or Treasury prior to 1979.

There follows a more comprehensive statement of our immediate response to the positions stated for the Treasury at the hearing.

(1) The suggestion that a business lessor be denied capital cost recovery tax allowances for investments in property leased to others because the lessee uses the prop-

erty for personal, non-business purposes is indefensible as a U.S. Treasury Department policy.

In stating opposition to the application of H.R. 1607 to TRAC leases of motor vehicles for non-business use, the following statement was made:

"We would object strongly to extending these tax benefits to financing transactions involving vehicles used for personal purposes."

I question whether the Treasury Department really means to espouse a policy that would make the entitlement to tax allowances for recovery of capital costs for a taxpayer engaged in the business of leasing or otherwise providing motor vehicles or any other kind of equipment depend on his customer's not using the equipment for personal or non-business purposes. I note that the IRS recently issued a Revenue Ruling (Rev. Rul. 83-109, I.R.B. 1983-32, 5) reaffirming that a leasing company is entitled to investment tax credits with respect to automobiles leased to individuals who use them for personal purposes.

(2) The position supporting IRS' efforts to treat open-end motor vehicle TRAC leases as conditional sales is wrong as a matter of non-tax law, is unsound as a proposed new federal tax policy, and is in conflict with the "net lease" policies in both the statute and the IRS' own Rev. Proc. 75-21 ruling guidelines.

Under the basic standards of non-tax law that apply to distinguish a true lease from a conditional sale, the motor vehicle TRAC lease classifies as a true lease for several reasons.

(1) A TRAC lessee doesn't have the ownership rights that a conditional purchaser usually has in property.

(2) A TRAC lessee doesn't make the cash down payment that is typically required of the conditional purchaser.

(3) A conditional seller doesn't have the responsibilities imposed on a TRAC lessor by various state and federal law in respect to accident liability, state and local taxes, motor vehicle traffic violations, insurance, etc.

(4) A TRAC lessee, unlike a conditional purchaser, doesn't become the full owner of the property upon making the rental payments required under the lease for the lease term

(5) A conditional seller, unlike a vehicle TRAC lessor, typically is not personally liable on indebtedness incurred to finance acquisition of the property.

Since the motor vehicle TRAC lease is a true lease under the usual standards that generally apply for non-tax purposes, the only question remaining is whether for purposes of federal tax law the congress should allow a change in the traditional and longstanding federal tax law practice, followed both by the lessors and lessees and by the IRS on audit of the tax returns, in respecting such leases as ones under which the lessors are allowed the depreciation deductions and other capital cost allowances provided under the tax laws.

In this connection, we would caution against accepting what seems to be the prevailing presumption held by certain IRS personnel that it is right and desirable to presume that a lease or any other transaction is not what it purports to be, absent some form of sham or tax avoidance transaction. Indeed, I suggest that the standard I suggest is the view laid down by the U.S. Supreme Court in its leading decision in the *Frank Lyon* case as the standard to be observed by the IRS.

Motor vehicle TRAC lease transactions are not tax avoidance transactions. The TRAC clause was conceived and is used for sound business cost control purposes, important both to lessors and to lessees, as was described by the business witnesses at the hearing.

I also would note that the IRS "burdens and benefits" test espoused in the position stated for the Treasury at the hearing presents several major difficulties.

First, it is an attempted end run by the IRS around the Congressionally enunciated policy as to "net leases" which clearly contemplates that a lessor is entitled to depreciation tax deductions and investment tax credits even though he is "either guaranteed a specified return or is guaranteed in whole or in part against loss of income" by lease provisions which shift to the lessee economic risks and burdens connected with the leased property. That policy has appeared in the statute itself, beginning at least as far back as the Tax Reform Act of 1969, in the "net lease" provisions now appearing in Code sections 48(d)(4)(D), 57(d)(1)(B), and 163(d)(4). The burdens and benefits test applied by the IRS in the regulation proposed in November of 1982 as to motor vehicle TRAC leases is in direct conflict with this law. This shows up in example (1) of that proposed regulation, where the IRS lists taxes, insurance, maintenance and repair expenses, operating expenses, and other particular costs associated with a leased automobile as ones for which the lessee is responsible and then concludes that "under these facts, [the lessor] has not retained significant and genuine attributes of ownership" and that the agreement is not a lease.

The way in which the IRS would apply its burdens and benefits tests to net motor vehicle operating leases also is contrary to its own policies followed extensively in allowing leveraged "net leases" of major equipment to be treated as leases under its Rev. Proc. 75-21 lease ruling guidelines.

Second, by looking to whether it is the lessee or lessor who pays taxes, insurance, or other particular costs associated with the leased property—instead of to which one bears the burden of such costs—the test urged by the IRS in important cases, treats the lessor as having the burden of costs for the property when he in fact does not; so that the test as applied does not really find "the economic reality" purportedly sought.

Third, even if the test were a true indicator of who has the burdens and benefits, the IRS has not been delegated authority by Congress even to get into the business of using such tests to recharacterize leases as something other than that, absent a clear showing that there is a sham transaction entered into for tax avoidance purposes. As the United States Supreme Court declared in its opinion in the *Frank Lyon Co.* case:

"We hold that where, as here, there is a genuine multiple party transaction with economic substance which is compelled or encouraged by business or regulatory reality, is imbued with tax independent consideration, and *is not shaped solely by tax avoidance features that have meaningless labels attached, the Government should honor the allocation of rights and duties effectuated by the parties.*" (435 U.S. at 583-4) (emphasis supplied).

Finally, even if the IRS' test were modified to correct its deficiencies in looking at who pays instead of who bears costs connected with leased property, and even if the law were changed to permit such a test to be applied to recharacterize leases as something else when there is NOT a sham tax avoidance transaction, it still would present a difficulty that suggests it is fundamentally unsound. I and other analysts of the subject have difficulty finding a single commercial lease transaction that would not be considered to be a sale under the IRS test. The very essence of a lease in Anglo-American commercial and legal tradition, dating from medieval English times to the present, is a "shifting" from the owner-lessor to the user-lessee, during the lease term, of the economic burdens and benefits associated with the property and a termination of the lessee's burdens and benefits at the end of the lease term when the reversionary interest of the owner-lessor takes effect. The mere fact that the IRS test would seem to treat all commercial lease transactions as sales should lead one to question whether there isn't something fundamentally wrong with the test. I suggest that the IRS test is hardly ripe for serious consideration by either Treasury or the Congress.

(3) It is misleading to state that the rule of law proposed in H.R. 1607 is a "guarantee of lease treatment" amounting to restoration of the now repealed safe harbor lease rules for one exceptional class of property.

An assertion that H.R. 1607 would "guarantee lease treatment" for federal income tax purposes of certain motor vehicle operating agreements appears in the written statement submitted at the hearing for the Treasury numerous times, including the very first page, the caption for the discussion of H.R. 1607, and at several other points where it is interwoven into the text of the statement.

H.R. 1607 clearly is not a safe harbor rule. The safe harbor rules enacted in '81 and repealed in '82 treated arrangements that satisfied the safe harbor rules as leases even though they were not. The basic objective of the '81 Act safe harbor lease provisions was simply to permit transferability of unused tax xredits and deductions, and the device used for achieving that end was to treat as leases transactions that never would have been thought of as leases. The motor vehicle TRAC lease, by sharp contrast, for more than 30 years had been respected as a lease for tax as well as non-tax purposes. H.R. 1607 does not create a lease when none exists. The agreement must be a true lease. H.R. 1607 merely prevents a true lease from being denied lease treatment because of the presence of a TRAC clause. In other words, where the safe harbor rules in the '81 Tax Act declared any agreement to be a lease if it was called that by the parties and met the few other conditions specified, H.R. 1607 does not declare that the presence of a TRAC clause requires a motor vehicle operating lease to be treated as a lease; it merely prevents the presence of a TRAC clause from being used to deny lease treatment. The agreement must meet all other requirements under law to be treated as a lease.

(4) It also is wrong to imply that use of a TRAC clause in an open-end motor vehicle operating lease does not lower the cost to the user for rental of the property.

The conclusion in the statement submitted for the Treasury that:

"If the value of the property declines below the estimated value, the loss, when added to the rents, may exceed the cost to the customer under a closed end agreement" implies that TRAC clauses ar not generally less costly to motor vehicle lessees than closed-end leases, but ignores several factors. On its face, it ignores the instances where the value of the property exceeds the estimated value and the gain is paid to the customer.

The Treasury statement offers no evidence of any factual basis to support the implication for Treasury that open-end leases do not lower cost to the customer. That implication flies straight into the face of studies and experience of lessors and lessees who have used both kinds of leases for more than 30 years, and ignores the evidence on the hearing record in the testimony offered by several industry witnesses who are in a position to know the facts. As those and other industry experts in the past have repeatedly stated, on whole the cost to the users for rental of vehicles necessarily is lower under an open-end lease containing a TRAC clause than closed-end lease without such a clause. This is because the direct rental adjustment made by such a clause for the difference between the vehicle resale value initially estimated by the parties and the vehicle resale value actually realized at the end of the lease makes it unnecessary for the open-end lessor to include in the rental a charge for "insurance" against underestimation of actual resale value.

(5) The statement submitted for the Treasury is simply wrong in its factual assertions that lease treatment of open-end motor vehicle TRAC leases is not long established for federal tax purposes and that the practice of the industry in so treating them was not tacitly approved by the IRS and Treasury, and in the implication in its Statement that the conditional sale treatment urged by the Service in 1979 in a technical advice memorandum on the audit disposition of one particular case did not represent the beginning of an effort to impose a change in the practice for IRS audit treatment of such leases.

The United States Tax Court, in the *Leslie Leasing Company* case, explicity recognized in its opinion that the IRS had had a longstanding audit position that recognized such clauses as true leases and that the policy change was made without notice to the public or opportunity for public comment. 80 T.C. 411 (1983).

A more comprehensive paper in support of H.R. 1607 and revenue estimates prepared by the staff of the Joint Committee on Taxation on a bill introduced by Senator Durenburger (S. 1161) that is identical to H.R. 1607 are attached hereto for inclusion in the record as appendices to this statement.

Appendix A

STATEMENT IN SUPPORT OF LEGISLATION TO REMOVE POWER OF THE TREASURY DEPARTMENT TO ISSUE REGULATIONS WITHOUT CONGRESSIONAL INVOLVEMENT THAT WOULD CHANGE EXISTING LAW WHICH PREVENTS PRESENCE OF A TERMINAL RENTAL ADJUSTMENT CLAUSE FROM DENYING LEASE TREATMENT OF OPEN-END MOTOR VEHICLE LEASES

Submitted on Behalf of
An Ad Hoc Group of U.S. Motor Vehicle Lessors,
Manufacturers and Dealers

Summary of Contents

A. THE PROPOSED LEGISLATION.

B. WHY THE PROPOSED LEGISLATION SHOULD BE ENACTED.

I. Removing the power of Treasury to change the rule of section 210 of TEFRA without Congressional involvement is desirable in order to insure that Congress will be involved in any policy change of tax law in this area, and is necessary to prevent a reversal of existinq law through administrative action rather than through the legislative type of deliberation and consideration that was contemplated when Congress enacted section 210 of TEFRA.

a. Section 210 of TEFRA was enacted not only to prevent the retroactive application of a new IRS audit position, but also to provide a rule for the future which could be changed by an IRS regulation only under "extraordinary circumstances" and then only after Treasury and the IRS had completed major policy-level studies addressing the tax and economic issues raised by such a change.

b. Contrary to Congressional intent, Treasury issued a proposed regulation (which it labeled as merely "interpretative") to reverse the rule contained in section 210 only 81 days after its enactment without conducting economic or policy studies contemplated by Congressional sponsors of section 210.

II. Removing the power of the IRS to issue a regulation reversing the rule set forth in section 210 of TEFRA will prevent a loss of revenue to the Treasury that could result from the issuance of such a regulation.

III. The exclusion from TEFRA section 210 of consumer leases of motor vehicles for personal use was inserted in section 210 of TEFRA at the last moment at the request of Treasury without appropriate consideration, and any rule that would make a distinction as to the lessor's tax treatment on the basis of the type of use of the property by the lessee should be made only by Congress after appropriate consideration and deliberation.

   a. As a matter of law and sound tax policy, no reasonable basis exists for distinguishing motor vehicle lease transactions on the basis of the type of use of the property by the lessee.

   b. Consumer leases for personal use are entitled to protection of the kind provided in section 210 of TEFRA against retroactive changes in IRS audit position just as much as commercial leases for business use, and are equally entitled to protection against ill-considered future administrative policy changes.

   c. Economic consultants conclude that application of the existing rule contained in section 210 of TEFRA to motor vehicles that are used for personal purposes should not result in a revenue loss.

IV. The rule provided by the proposed legislation is consistent with substantial judicial authority.

   a. The existence of a terminal rental adjustment clause is not inconsistent with lease treatment under the holding of the U.S. Supreme Court.

      1. The U.S. Supreme Court in essence has instructed the IRS to stay out of the business of recharacterizing lease transactions as sales where the form of the transaction is not principally motivated by tax avoidance features.

      2. Motor vehicle leases in general, and terminal rental adjustment clauses contained therein, are motivated by business and economic realities, not by tax avoidance.

      3. Open-end motor vehicle lessors retain genuine and significant attributes of a traditional lessor.

   b. Although the only justification given by the IRS for issuance of the proposed regulation to reverse the rule of section 210 of TEFRA is of a technical nature, the lower courts, being divided on this very issue, do not even consistently support the IRS technical position.

V. Failure to enact the proposed legislation will allow the IRS to proceed with the issuance of regulations reversing the rule of section 210 of TEFRA that will have serious adverse consequences to motor vehicle lessors, dealers and manufacturers, but which will provide no significant benefit to the public or the government.

VI. Enactment of the proposed legislation is not inconsistent with the decision of Congress to repeal safe harbor leasing.

VII. Codification of Federal income tax statutes is a valuable aid to tax practitioners, taxpayers, and IRS personnel to enhance compliance with and administration of the nation's tax laws.

VIII. Revenue Effect of Proposed Legislation.

   a. As to commercially leased automobiles for business use, economic consultants conclude that enactment of the proposed legislation will not result in a revenue loss and could result in an increase in government revenues in the short run by as much as $300 million to $900 million and thereafter by as much as $85 million annually.

   b. As to consumer leases of automobiles for personal use, economic consultants conclude that enactment of the proposed legislation is unlikely to result in a revenue loss.

IX. Conclusion.

A. THE PROPOSED LEGISLATION

The proposed legislation will

(1) remove the power of the Treasury Department to issue regulations without the involvement of Congress that would change the existing rule of law set forth in section 210 of TEFRA, which provides that the existence of a terminal rental adjustment clause in certain motor vehicle agreements will not be taken into account in determining whether such agreement constitutes a lease for Federal income tax purposes,

(2) remove the limitation presently contained in section 210 of TEFRA relating to motor vehicles that are used for personal purposes, and

(3) codify the existing rule of law as set forth in section 210 of TEFRA.

B. WHY THE PROPOSED LEGISLATION SHOULD BE ENACTED

I. Removing the power of Treasury to change the rule of section 210 of TEFRA without Congressional involvement is desirable in order to insure that Congress will be involved in any policy change of tax law in this area, and is necessary to prevent a reversal of existing law through administrative action rather than through the legislative type of deliberation and consideration that was contemplated when Congress enacted section 210 of TEFRA.

Section 210 of the Tax Equity and Fiscal Responsibility Act of 1983 ("TEFRA"), which was signed into law by the President on September 3, 1982, provides that the existence of a terminal rental adjustment clause in a "qualified motor vehicle agreement" shall not be taken into account in determining whether such agreement is a lease. A qualified motor vehicle agreement is defined in section 210 of TEFRA as an agreement with respect to a motor vehicle (1) entered into prior to the enactment of any law or the publication of a regulation providing a contrary rule, (2) with respect to which the lessor is personally liable for repayment of all amounts borrowed to finance the leased property, and (3) with respect to which the lessee uses the leased property in a business or for the production of income. A "terminal rental adjustment clause" is defined as a provision permitting or requiring an adjustment to the rent by reference to the amount realized by the lessor on the sale of the leased property. Although section 210 of TEFRA does not prevent Treasury from issuing contrary rules on a prospective basis, section 210 and its legislative history neither requires nor encourages the adoption of a regulation to reverse the rule stated in section 210. To the contrary, the principal sponsors and supporters in the Senate and in the House intended that a reversal of the existing law expressed in section 210 would occur only through legislative type of deliberation.

a. Section 210 of TEFRA was enacted not only to prevent the retroactive application of a new IRS audit position, but also to provide a rule for the future which could be changed by an IRS regulation only under "extraordinary circumstances" and then only after Treasury and the IRS had completed major policy-level studies addressing the tax and economic issues raised by such a change.

One of the purposes of Congress in enacting section 210 of TEFRA was to prevent the retroactive application of a new IRS audit position reflected in an Internal Revenue Service Technical Advice Memorandum issued by the National Office in December 1979 (LTR 8019120) that would have reversed a longstanding audit position recognizing leases containing terminal rental adjustment clauses (which had been used by the motor vehicle fleet leasing industry for more than 30 years) as true leases. The intent of Congress, however, was far broader than to simply prevent retroactive application of the new IRS audit position. Congress, in enacting section 210, intended to provide a rule for the future which could be changed by an Internal

Revenue Service regulation only under extraordinary circumstances and then only after Treasury and the IRS had completed major policy-level studies that addressed economic issues in addition to addressing technical tax considerations. Had Congress intended to simply provide retroactive relief, it presumably would have made section 210 applicable only to transactions entered into prior to a date certain. Furthermore, if Congress had intended to allow the Internal Revenue Service to reverse the rule of section 210 on the sole basis of technical tax considerations without also considering important policy and economic issues resulting from such a change, Congress presumably would have permitted the Internal Revenue Service to change the rule prospectively through the simple issuance of a Revenue Ruling.

The legislative history and views of the principal sponsors of the legislative proposals that were ultimately enacted as section 210 of TEFRA support the view that any reversal of section 210 would not occur without a legislative type of deliberation and consideration and that any change in section 210 through an IRS regulation would be based only on extraordinary circumstances after completion of policy-level studies addressing both tax and economic issues. The first bill on this subject (H.R. 8073) was introduced in 1980 by the then-Chairman of the House Committee on Ways and Means. Hearings were held on the bill in September 1980. HEARING ON FOREIGN CONVENTION TAX RULES AND MINOR TAX BILLS BEFORE THE SUBCOMMITTEE ON SELECT REVENUE MEASURES OF THE HOUSE COMMITTEE ON WAYS AND MEANS, September 8, 1980, 96th Cong., 2d Sess., at 270-283. This bill and an identical bill introduced in the Senate would have provided only retroactive relief.

In June 1981, Congressman Gibbons and former Congresssman Bafalis introduced H.R. 3857 which would have provided prospective as well as retroactive relief. This bill would have required legislative action by Congress before the IRS could reclassify a motor vehicle lease because of the presence of a terminal rental adjustment clause. In his statement on introduction of the bill, Mr. Gibbons made it clear that the bill "solves the problems created by the Technical Advice Memorandum for future as well as for past years" and emphasized that proposals for change would have to grow out of "careful study of the policy and technical issues that would be involved in not treating a business lease as such for tax purposes" and be submitted to Congress for legislative enactment. See, 127 Cong. Rec. E2849 (daily ed., June 9, 1981). The 97th Congress ended without enactment of Mr. Gibbons' bill. In May 1982, H.R. 6358 was introduced by Congressman Vander Jagt and former Congressman Holland. H.R. 6358 provided a rule of law for the future as well as for the past but, like section 210 of TEFRA, would have allowed a change to be effected by legislation or by prospective Treasury Department regulation. In introducing the bill, Mr. Holland stated that his bill was based on the premise that neither Congress nor the Treasury Department would consider a prospective change until the Treasury Department had conducted a "major policy-level study of the economic and tax issues" as to whether sufficient reason existed to require a change. Mr. Holland further stated:

> My bill does not require such a study. However, it certainly contemplates that no change would be made without a thorough analysis of these issues. 128 Cong. Rec. E2166 (daily ed., May 12, 1981).

On the Senate side, the Finance Committee in its amendment to H.R. 4961 included a provision substantially the same as the Holland bill. Senator Bentsen who, together with Senator Armstrong, were the principal sponsors of this provision which ultimately was enacted as section 210 of TEFRA, stated (referring to himself and to Senator Armstrong) that "it was our intent to include in the Committee-reported bill the substance of legislation we had drafted which was identical to the Holland bill, H.R. 6358," and that "his bill was based on the premise neither Congress nor the Treasury Department would consider any changes to existing law unless the Department had previously conducted a major policy-level study of the economic and tax issues bearing on the question whether there is sufficient reason to deny fleet lessors the depreciation and investment tax credits otherwise allowed owner-lessors of depreciable business property." Senator Bentsen further stated that he and Senator Armstrong "shared Mr. Holland's view that such a change could be effected by prospective Treasury Department regulations only in the most extraordinary circumstances", and that "the Committee clearly did not intend that Treasury exercise an unfettered discretion in publishing a regulation". See, Exchange of correspondence between Senator Bentsen and Congressman Matsui, 128 Cong. Rec. E3867 (daily ed., August 12, 1981).

b. Contrary to Congressional intent, Treasury issued a proposed regulation (which it labeled as merely "interpretative") to reverse the rule contained in section 210 only 81 days after its enactment without conducting economic or policy studies contemplated by Congressional sponsors of section 210.

On November 23, 1982, only 81 days after the enactment of section 210, Treasury issued a proposed regulation to reverse the rule contained in section 210. Contrary to Congressional intent, Treasury conducted no economic or policy studies. Treasury and IRS considerations were limited to the technical issues that would have been involved in the issuance of a Revenue Ruling. Not only did Treasury fail to make any effort to comply with the Congressional intent that economic and tax policy studies first show the need for any change in the rule of section

210, but asserted in its Notice of Proposed Rulemaking that "the notice and public procedure requirements of 5 U.S.C. §553 do not apply because the rules proposed are interpretative". The failure of Treasury to conduct the important policy and economic studies contemplated by Congress in delegating legislative authority to Treasury and the view of Treasury that its proposed regulation is merely interpretative in disregard of the fact that its proposed regulation would reverse a rule of law enacted by Congress, make it necessary and desirable that the power of Treasury to change the rule of section 210 of TEFRA without Congressional involvement be removed.

II. Removing the power of the IRS to issue a regulation reversing the rule set forth in section 210 of TEFRA will prevent a loss of revenue to the Treasury that could result from the issuance of such a regulation.

Economic studies conducted by Emil M. Sunley and Gerard M. Brannon conclude that enactment of the proposed legislation will not result in a revenue loss to the Government, but would prevent a loss of revenue that could result if Treasury were to issue a final regulation similar to that proposed. Finalization of the proposed regulation could result in a revenue loss as great as $300 million to $900 million in the short run and $85 million annually thereafter. See, Section VIII, Revenue Effect of Proposed Legislation, for further discussion.

III. The exclusion from TEFRA section 210 of consumer leases of motor vehicles for personal use was inserted in section 210 of TEFRA at the last moment at the request of Treasury without appropriate consideration, and any rule that would make a distinction as to the lessor's tax treatment on the basis of the type of use of the property by the lessee should be made only by Congress after appropriate consideration and deliberation.

The proposal as initially sought by Senators Bentsen and Armstrong, as well as H.R. 6358 introduced by Mr. Holland and Mr. Vander Jagt in 1982 and earlier legislative proposals, would all have applied without regard to the type of use by the lessee. The limitation in section 210 of TEFRA involving personal use of motor vehicles was inserted at the last moment during the Senate Finance Committee markup proceeding at the request of Treasury. Although the Treasury request for the unusual limitation was probably prompted by initial fears of a potential revenue loss associated with leasing for personal use, appropriate consideration was not given to the tax policy and revenue implications of the limitation, and no negative inference was intended. See, Exchange of correspondence between Senator Bentsen and Congressman Matsui, 128 Cong. Rec. E3867 (daily ed., August 12, 1981). Adoption of such an unusual rule that would distinguish the lessor's tax treatment on the basis of the type of use by the lessee should be made only by Congress after appropriate consideration of the tax policy and economic implications.

III. The exclusion from TEFRA section 210 of consumer leases of motor vehicles for personal use was inserted in section 210 of TEFRA at the last moment at the request of Treasury without appropriate consideration, and any rule that would make a distinction as to the lessor's tax treatment on the basis of the type of use of the property by the lessee should be made only by Congress after appropriate consideration and deliberation.

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recognize leases with such clauses as true leases. Leslie Leasing Co., 80 T.C. 411 (1983). This longstanding audit position made no distinction based on use by the lessee. Leases for personal use should be afforded the same protection against retroactive changes in IRS audit position as were afforded leases for business use by section 210 of TEFRA. Consumer leases are equally entitled to protection against ill-considered future administrative changes undertaken without appropriate policy and economic considerations.

c. Economic consultants conclude that application of the existing rule contained in section 210 of TEFRA to motor vehicles that are used for personal purposes should not result in a revenue loss.

Economic consultants to the ad hoc group have concluded that extension of the rule set forth in section 210 of TEFRA to consumer leases should not result in a revenue loss. See, Section VIII, Revenue Effect of Proposed Legislation, for further discussion.

IV. The rule provided by the proposed legislation is consistent with substantial judicial authority.

The IRS, in advocating the position adopted in its proposed regulation, has asserted as the ground therefor that from a technical standpoint lease agreements with terminal rental adjustment clauses should be properly treated for income tax purposes as conditional sales contracts. We do not believe that "technical purity" provides a sufficient basis in the present circumstances for reversal of the rule contained in section 210 of TEFRA in view of the adverse economic consequences and lack of revenue gain or other form of benefit to the public that would result from such a change (See, Sections V and VIII of this statement). But even from a technical standpoint, the position adopted by the IRS in its proposed regulation is suspect under the holding of the Supreme Court and is not uniformly supported by the decisions of the lower courts on this very issue.

a. The existence of a terminal rental adjustment clause is not inconsistent with lease treatment under the holding of the U.S. Supreme Court.

In Frank Lyon Co. v. United States, 435 U.S. 561 (1978), the Supreme Court, in addressing a conflict between the Eighth Circuit and the Fourth Circuit, mandated the standard for characterizing a lease transaction for federal income tax purposes. In holding that the transaction under consideration constituted a lease for federal income tax purposes, the Supreme Court rejected the narrow application of the burdens and benefits of ownership test on which the proposed regulation is grounded. Instead, the Supreme Court adopted an approach that examined the intent of the parties, the economic substance, and the extent to which the transaction had been structured for tax avoidance purposes:

> [W]e hold that where, as here, there is a genuine multiple party transaction with economic substance which is compelled or encouraged by business or regulatory realities, is imbued with tax independent considerations, and is not shaped solely by tax avoidance features that have meaningless labels attached, the Government should honor the allocation of rights and duties effectuated by the parties. 435 U.S. at 583-4.

Application of this holding indicates that the existence of a terminal rental adjustment clause in motor vehicle leases is not inconsistent with lease treatment for federal income tax purposes.

1. The U.S. Supreme Court in essence has instructed the IRS to stay out of the business of recharacterizing lease transactions as sales where the form of the transaction is not principally motivated by tax avoidance features.

The Supreme Court in Lyon has effectively instructed the IRS to honor the allocation of rights and duties effectuated by the parties where the form of the transaction is not motivated by tax avoidance features. This instruction is indeed sound from both a technical and policy viewpoint. The IRS need not be involved as an arbiter to determine the correct characterization of every business lease transaction where tax avoidance features are not present.

2. Motor vehicle leases in general, and terminal rental adjustment clauses contained therein, are motivated by business and economic realities, not by tax avoidance.

Motor vehicle lease transactions are not generally motivated by tax avoidance features. From the lessor's standpoint, most motor vehicle leasing companies are engaged in the business of motor vehicle leasing to realize a profit from the leasing transactions rather than to shelter income from non-leasing activities. Indeed, the principal source of income for many motor vehicle lessors is the income derived from motor vehicle leasing transactions. Likewise, the decision of motor vehicle users to lease rather than own vehicles is not typically motivated by tax reasons. For example, fleet lessees typically choose to lease rather than own vehicles for sound business reasons, such as: (1) the conservation of working capital by avoiding an initial large cash investment; (2) the ability to obtain the use of business assets without violating potential restrictons on borrowings or regulatory requirements; and (3) "off-balance sheet financing", enabling lessees the use of a large fleet of late-model vehicles without impairing financial statements. Additional evidence that motor vehicle lease transactions are compelled by business and economic realities and not tax avoidance is found in the fact that motor vehicle lease transactions with terminal rental adjustment clauses have been widespread for more than 30 years, thus predating the investment tax credit and ACRS provisions of the Internal Revenue Code, as well as the fact that enactment of the proposed legislation will not result in a revenue loss to the government.

Use of terminal rental adjustment provisions in motor vehicle leases serve important business purposes and are compelled by economic realities. First, utilization of the terminal rental adjustment clause recognizes the economic fact that the motor vehicle lessee is better able than the lessor to control the costs of using the vehicles through proper maintenance, careful operation, and extent and type of use. In the absence of a terminal rental adjustment clause, the lessor would find it necessary to charge a higher rent to protect itself against poorer maintenance or more extensive or greater use of the vehicle than was originally contemplated. Moreover, utilization of "wear and tear" clauses that are typically found in closed-end motor vehicle leases inevitably lead to costly and unnecessary disputes between the lessor and lessee. Thus, cost efficiency is the fundamental economic reality motivating terminal rental adjustment clauses, not tax avoidance.

3. Open-end motor vehicle lessors retain genuine and significant attributes of a traditional lessor.

Consistent with the holding in Lyon, motor vehicle lessors in open-end lease transactions retain genuine and significant attributes of a traditional lessor. The lessor is treated as the owner of the vehicle for state law purposes, which impose requirements to comply with state insurance, registration and titling requirements, liability for personal property taxes, liability for parking and other motor vehicle violations, and potential liability to third parties for damages caused by the vehicles. As vehicle owners, the lessors are subject to disclosure and recordkeeping requirements imposed by federal law. For financial accounting purposes, the vehicles are treated as assets of the lessor rather than of the business lessee and the corresponding liability for funds borrowed to finance the acquisition of the vehicles is primarily that of the lessor, not the lessees. Conversely, in a conditional sale, the liability to the third party lender is primarily that of the vehicle user.

Other important factors are also present which are consistent with traditional lessor status. In most cases, leasing is a principal or exclusive activity of the lessor. Many of the larger motor vehicle lessors have been in business for several decades.

b. Although the only justification given by the IRS for issuance of the proposed regulation to reverse the rule of section 210 of TEFRA is of a technical nature, the lower courts, being divided on this very issue, do not even consistently support the IRS technical position.

The Tax Court and the Ninth Circuit have had occasion to consider the appropriate classification of a motor vehicle lease with a terminal rental adjustment clause from a technical viewpoint. Swift Dodge, 76 T.C. 547 (1981), rev'd, 692 F.2d 651 (9th Cir., 1982); Leslie Leasing Co., 80 T.C. 411 (1983). Swift Dodge was decided by both the Tax Court and the Ninth Circuit without application of section 210 of TEFRA. The Tax Court held that a motor vehicle lease with a terminal rental adjustment clause constituted a valid lease for federal income tax purposes. The Ninth Circuit held a contrary view. In Leslie Leasing Co. the Tax Court applied section 210 to the business leases, but as to the personal use leases which were not covered by section 210 of TEFRA, because the taxpayer's appeal would lie with the Ninth Circuit, the Tax Court was constrained to follow the holding of the Ninth Circuit under the principles of Golsen, 54 T.C. 742 (1970), aff'd, 445 F.2d 985 (10th Cir., 1971), cert. denied, 404 U.S. 940 (1971). The Tax Court in Leslie Leasing, however, gave no indication that it intends to follow the Ninth Circuit decision in cases appealable to other circuits where the constraints of

Golsen are not present. Thus, the technical position asserted by the Internal Revenue Service as the ground supporting the position taken in the proposed regulation does not even find consistent support in the decisions of the courts that have had occasion to consider the issue on a technical, substantive basis.

V. Failure to enact the proposed legislation will allow the IRS to proceed with the issuance of regulations reversing the rule of section 210 that will have serious adverse consequences to motor vehicle lessors, dealers and manufacturers, but which will provide no significant benefit to the public or the government.

Failure to enact the proposed legislation will allow the IRS to proceed with the issuance of regulations reversing the rule of section 210 of TEFRA. The issuance of such regulations will provide no revenue increase or any other significant benefit to the public or the government. To the contrary, the issuance of such regulations may cause a significant detriment to the public and the government in the form of decreased revenues, increased administrative costs that will inevitably arise from renewed litigation involving the validity of the position taken in the regulations and increased motor vehicle costs.

Although reversal of the rule of section 210 will provide no significant benefit to the public or the government, it will have serious adverse consequences to motor vehicle lessors, dealers, and manufacturers. If the Treasury regulations were adopted effective on the date of publication, there will clearly be a very significant short-term disruption. All contracts would have to be rewritten and executives within each company would have to consider the new terms and conditions. During the adjustment period, the path of least resistance for many vehicle users would be to defer delivery of new automobiles. Economic analyses indicate that the short-term disruption would likely last at least three months, and could last as long as six to nine months. The analyses further indicate that each month delay in replacing leased vehicles would result in a loss of 125,000 new car purchases with a sales value of $1.2 billion. This analysis is based on the estimate that 3.5 million cars are currently leased to businesses under open-end leases with terminal rental adjustment clauses and that the leased cars turn over on average every 28 months. A three-month delay would, thus, result in a loss of 375,000 new car purchases with a sales value of $3.7 billion.

The adverse consequences to motor vehicle lessors, dealers, manufacturers and users would not be limited to the short run. Users of automobiles who lease under open-end arrangements do so because it is the most efficient alternative. To the extent that denial of lease treatment for such arrangements discourages this form of transaction (which is by far the most prevalent form of motor vehicle leasing), any other form of transaction must be assumed to be less efficient and more costly. For example, closed-end leases are generally more expensive to the user than open-end leases because the lessor must be compensated for the additional risks which are within the lessee's control but which the lessor would assume. Assuming unit elasticity of demand, for every 1 percent increase in user costs, there will be a 1 percent reduction in the number of vehicles put into service. Based on industry studies, a 1 percent annual increase in costs would translate into a reduced annual demand for approximately 17,000 new cars, with an annual effect on the U.S. economy of approximately $170 million.

An increase in the cost of leasing could also cause motor vehicle users to purchase rather than lease the vehicles. Owned vehicles are carried as capital assets on a company's balance sheet and are subject to all the cost and budget controls generally imposed on capital asset acquisitions. This process translates into longer holding periods and less frequent replacement cycles for owned vehicles than for leased vehicles. An economic study prepared for the American Automotive Leasing Association indicates that the average holding period for leased business vehicles is approximately 28 months, compared to

32 months for owned vehicles. A permanent four-month delay in the replacement cycle could result in an annual loss of 200,000 new car and light truck purchases with a value of $2 billion.

VI. Enactment of the proposed legislation is not inconsistent with the decision of Congress to repeal safe harbor leasing.

Motor vehicle lease transactions with terminal rental adjustment clauses should not be confused with the concept of safe harbor leasing which was enacted in 1981 as a part of the Economic Tax Recovery Act and repealed by TEFRA in 1982. They lie at opposite ends of the tax spectrum. The intent of Congress in enacting safe harbor leasing was to provide a means for transferring tax benefits rather than a means of determining which person was in substance the owner of the property. *See*, S. Rept. No. 97-494, Vol. 1, 97th Cong. 2d Sess., p. 130; H. Rept. No. 97-760, 97th Cong. 2d Sess., p. 492. Safe harbor lease transactions often did not bear any resemblance to a lease. As explained by the staff of the Joint Committee on Taxation:

> [A] transaction generally will not be given effect for tax purposes unless it serves some business purpose aside from reducing taxes. Because the leasing provision was intended to be only a transferability provision, many of the transactions that will be characterized as a lease under the safe harbor will have no business purpose (other than to transfer tax benefits). When the substance of the transaction is

> examined, the transaction may not bear any resemblance to a lease. Jt. Comm. on Taxation, General Explanation of the Economic Recovery Tax Act of 1981, p. 104.

In repealing safe harbor leasing, three basic reasons were advanced: (1) concern that some taxpayers utilized safe harbor rules to avoid their equitable share of tax, (2) the derivative effect of eroding respect for and compliance with the tax laws on the part of other taxpayers, and (3) to prevent what was viewed as significant revenue losses attributable to safe harbor leasing.

Motor vehicle leases with terminal rental adjustment clauses bear no resemblance to safe harbor leases either in form, substance or intent of the parties. Whereas safe harbor leases were developed primarily to permit a sale of tax benefits, motor vehicle leases with terminal rental adjustment clauses are not tax motivated and are entered into for substantial business purposes. Whereas safe harbor transactions resulted in substantial revenue losses to the government, motor vehicle leases with terminal rental adjustment clauses result in no revenue loss. The form and substance of the two transactions are also entirely different. In a typical safe harbor lease, the lessee often retained title to the property and in those cases where title was not retained by the lessee, the lessee could acquire title through payment of a nominal sum (such as $1) even though substantial residual value remained in the property at the end of the lease term. Conversely, the lessor in a typical safe harbor lease anticipated no benefits or profits from ownership of the property (other than the tax benefits) and typically had no interest in the residual value of the property at the end of the lease term. In open-end motor vehicle lease transactions, the lessor is the owner of the property for local law purposes, expects to realize a profit from the transaction independent of tax benefits and normally realizes substantial residual value from the motor vehicle at the termination of the lease.

Accordingly, in contrasting the stark differences between safe harbor transactions and motor vehicle leases with terminal rental adjustment clauses, there is no inconsistency in enactment of the proposed legislation with the decision of Congress to repeal safe harbor leasing.

VII. Codification of Federal income tax statutes is a valuable aid to tax practitioners, taxpayers, and IRS personnel to enhance compliance with and administration of the nation's tax laws.

The present rule of law regarding certain motor vehicle lease agreements with terminal rental adjustment clauses does not appear in the Internal Revenue Code but, rather, appears only as section 210 of TEFRA.

Codification of the rule would provide aid to tax practitioners, taxpayers and IRS personnel in complying with and administering the tax law. Simply stated, codification of the provision will enable affected people to find it.

VIII. Revenue Effect of Proposed Legislation

Economic consultants to the ad hoc group, Emil M. Sunley and Gerard M. Brannon, have concluded that enactment of the proposed legislation will not result in a revenue loss to the government, but may prevent a revenue loss that could occur if the proposed regulations are finalized.

a. As to commercially leased automobiles for business use, economic consultants conclude that enactment of the proposed legislation will not result in a revenue loss and could result in an increase in government revenues in the short run by as much as $300 million to $900 million and thereafter by as much as $85 million annually.

The economic consultants to the ad hoc group have concluded that as to motor vehicles leased for business use, enactment of the proposed legislation will not result in a revenue loss, but would prevent a loss of revenue that could result from issuance of the proposed regulations by as much as $300 million to $900 million in the short run and thereafter by as much as $85 million annually. Their conclusions are summarized as follows:

(1) To the extent that the proposed legislation is viewed as a continuation of existing law embodied in section 210 of TEFRA, the enactment of the proposed legislation would, of course, not result in any revenue gain or loss.

(2) The following conclusions are based on a comparison of the proposed legislation to the rule set forth in the proposed regulations.

  (a) As previously explained, if the proposed regulation is adopted effective the date of publication, a significant short-term disruption would occur resulting in a delay in replacement of leased vehicles. The disruption is likely to last at least three months. Each month delay in replacing leased vehicles would result in reduced sales of approximately $1.2 billion. Assuming that a loss in automobile sales translates dollar-for-dollar into a loss of GNP, and further assuming a 24 percent tax rate on changes in GNP, it is estimated that a one-month delay in replacing leased vehicles would reduce government revenues by $300 million and a three-month delay would reduce government revenues by $900 million.

(b) In the long run, enactment of the proposed legislation will not result in a revenue loss, but, depending upon the response of business to a regulatory reversal of section 210 of TEFRA, could prevent a revenue loss of as much as $85 million annually. One possible response to finalization of the proposed regulation would be to continue to use leases with terminal rental adjustment clauses, but to treat the leases as conditional sales for tax purposes. Assuming that rentals are increased sufficiently to compensate the lessor for a loss of tax benefits, the user would have a higher tax basis than the lessor, thereby increasing the total amount of accelerated cost recovery deductions and investment tax credit. It is estimated that the government would lose revenue of approximately $50 per motor vehicle. If all motor vehicle leases with terminal rental adjustment clauses were switched to conditional sales in this fashion, the annual revenue loss resulting from failure to enact the legislation would be approximately $85 million.

b. As to consumer leases of automobiles for personal use, economic consultants conclude that enactment of the proposed legislation is unlikely to result in a revenue loss.

The economic consultants have concluded that as to motor vehicles leased for personal use, enactment of proposed legislation is unlikely to result in a revenue loss.

IX. Conclusion

Enactment of the proposed legislation is desirable to insure that Treasury will not change the existing rule of law embodied in section 210 of TEFRA without Congressional involvement and without the type of deliberation and consideration that was contemplated by Congress when it enacted section 210 of TEFRA. Enactment of the proposed legislation will not result in a revenue loss to the government, but will prevent a loss of revenue to the government that could result from the issuance of a regulation reversing the rule set forth in section 210 of TEFRA. Although allowing the Treasury to issue regulations reversing the rule of section 210 of TEFRA will not raise any revenue and will provide no other significant form of benefit to the government or the public, such regulations will have serious adverse consequences to motor vehicle lessors, dealers, manufacturers, and users. Achievement of "technical purity," the only ground asserted by the IRS in support of its proposed regulation, does not (even if that purpose were accomplished, which it is not) constitute sufficient reason for causing serious disruption and economic harm to the motor vehicle industry, particularly where no revenue gain or other form of significant benefit to the government or the public is achieved. But even from a technical standpoint, the position advocated by the IRS in its proposed regulations is inconsistent with the holding of the Supreme Court and lacks consistent support in the lower courts. As to motor vehicles used for personal use, no reasonable basis exists for distinguishing between motor vehicle lease transactions on the basis of the type of use of the property by the lessee. This is especially true since no revenue loss should be involved.

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of U.S. motor vehicle lessors,
manufacturers and dealers*

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* Participants in the ad hoc tax group include the organizations listed below.

[See next page]

Lessors

PHH Group, Inc. & affiliates	Baltimore, Maryland area
Gelco Corporation & affiliates	Minneapolis, Minnesota,
Leaseway Transportation Corporation	Cleveland, Ohio
Wheels, Inc.	Chicago, Illinois
Bankers Leasing Corporation (a subsidiary of the Southern Pacific Corporation)	San Francisco, California area
U.S. Fleet Leasing Company (a subsidiary of U.S. Leasing International)	San Francisco, California area
National Car Rental Systems (a subsidiary of Household International)	Minneapolis, Minnesota Chicago, Illinois area
Dart & Kraft Leasing (a subsidiary of Dart & Kraft Inc.)	Minneapolis, Minnesota Chicago, Illinois area
Kerr Management Corp.	Denver, Colorado area
Glesby Leasing	Houston, Texas
Moore Leasing	Portland, Oregon
AMI Leasing Group	Worcester, Massachusetts and Rhode Island
American Automotive Leasing Association (AALA)	Milwaukee, Wisconsin and Washington, D.C.
Dresser Leasing Corporation	Pittsburgh, Pennsylvania
RTR Transportation Corp.	Rochester, New York

Lessees

Various lessee organizations around the country also are cooperating informally with the work of the ad hoc tax group.

Dealers

National Automobile Dealers Association (NADA) & numerous member dealer organizations in the U.S.	Washington, D.C.

Manufacturers

General Motors Corporation	Detroit, Michigan
Ford Motor Company	Detroit, Michigan
Chrysler Corporation	Detroit, Michigan

Labor

United Auto Workers (UAW)	Washington, D.C.

Appendix B

98TH CONGRESS 1ST SESSION
MEMBERS

HOUSE
DAN ROSTENKOWSKI ILL.
CHAIRMAN
SAM GIBBONS FLA.
J.J. PICKLE TEX.
BARBER B. CONABLE JR. N.Y.
JOHN J. DUNCAN TENN.

SENATE
ROBERT DOLE KANS.
VICE CHAIRMAN
BOB PACKWOOD OREG.
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RUSSELL B. LONG LA.
LLOYD BENTSEN TEX.

Congreſs of the United States
JOINT COMMITTEE ON TAXATION
1015 LONGWORTH HOUSE OFFICE BUILDING
Washington, D.C. 20515

DAVID H. BROCKWAY
CHIEF OF STAFF
RICHARD A. GORDON
DEPUTY CHIEF OF STAFF (LAW)
JAMES W. WETZLER
DEPUTY CHIEF OF STAFF (ECONOMICS)

SEP 26 1983

Honorable Dave Durenberger
United States Senate
Washington, D.C. 20510

Dear Senator Durenberger:

On May 13, 1983 you requested a revenue estimate for S. 1161. The bill would override preliminary Treasury Department regulations which deem certain vehicle leases with terminal rental adjustment clauses to be conditional sales transactions. For purposes of preparing the estimate it was assumed that the proposed regulations would be made final on December 31, 1983.

	Fiscal Year (Millions of Dollars)				
	1984	1985	1986	1987	1988
S. 1161	-45	-7	44	47	52

Sincerely,

David H. Brockway

David H. Brockway

Appendix C 11/3/83

H.R. 1607

A bill to amend the Internal Revenue Code of 1954 to make it clear that certain motor vehicle operating leases are leases

EXPLANATION

H.R. 1607 makes clear that a terminal rental adjustment clause (TRAC) in a motor vehicle operating lease will not be taken into account in determining whether an agreement is a lease for Federal tax purposes if the lessor either is personally liable for repayment or has pledged certain other property as security for amounts borrowed to finance the acquisition of the property. The bill would be effective for all agreements regardless of whether they were entered into before or after the effective date of the act.

A terminal rental adjustment clause (TRAC) is a provision in an agreement that permits or requires an adjustment in the rental price based on the amount realized on the disposition of the property at the termination of the lease. (For description of what a TRAC lease is, see below.)

H.R. 1607 provides the same rules as provided by section 210 of TEFRA (attached), except for two modifications:

(1) The general rule provided by the bill can be terminated or modified only by Congress.

(2) The general rule is extended to property leased for personal use.

Enactment of this bill will settle a controversy that many Members thought should never have arisen and that was thought to have been settled by section 210 of TEFRA. Section 210 permitted the general rule to be terminated either by further act of Congress or by the publication of a regulation providing that any agreement with a TRAC clause is not a lease. However, the legislative history makes clear that Congressional sponsors of section 210 expected this regulatory power to be exercised only under extraordinary circumstances and then only after completion of tax policy and economic impact studies.

With great haste and without the economic or other studies contemplated by sponsoring Members of Congress, a regulation labeled "interpretative" was proposed less than 3 months after the enactment of TEFRA. No Regulatory Impact Analysis required by Presidential Executive Order 12291 was made on the alleged ground that the proposed rule is not a major rule. No Regulatory Flexibility Analysis was made on the alleged ground that the proposed rules are interpretative.

The bill, basically, is revenue neutral. Attached is the revenue estimates by the staff of the Joint Committee on Taxation for S. 1161, an identical bill.

The bill is supported by motor vehicle lessors, manufacturers, dealers, workers, and users.

REASONS

The need for H.R. 1607 arises from efforts the IRS recently has made to change the traditional federal tax treatment of TRAC leases both as to commercial TRAC leases to business users and as to consumer TRAC leases to personal users. The treatment traditionally accorded such leases for over 30 years, both by lessors and by the IRS on audit of their tax returns, was to treat the lessor as the owner of the vehicle and as the party entitled to depreciation and other capital cost recovery tax allowances. The change sought by the IRS would treat the lessee instead of the lessor as the owner and deny capital cost recovery tax allowances to the lessor, shifting them instead to the lessee if he is a busines user.

The IRS has attempted to make this change not by seeking Congressional enactment of a change in the law, but by administrative actions alone. Initially the IRS attempted to impose this change both retroactively and prospectively by disallowing capital cost recovery tax allowances on its audit of lessors' tax returns, and in pursuit of the audit tax deficiencies in litigation in the courts. However, since the enactment in 1982 of section 210 of TEFRA, it has sought to accomplish that result prospectively as to commercial leases through a regulation it proposed in November 1982, just 81 days after Congressional enactment of section 210 expressing a contrary policy view, and it is still seeking to accomplish that result retroactively as to consumer leases through audits and litigation.

The basic purpose of H.R. 1607 is to permit continuation of the traditional tax treatment of TRAC leases - which is to disregard the presence of a TRAC clause in determining whether to respect a lease as such for tax purposes - unless and until Congress enacts a further law providing that an agreement with a TRAC clause is not a lease. H.R. 1607 would permit continuation of such traditional tax treatment in the case of commercial leases for business use and consumer leases for personal use, whether entered into before or after its enactment. Enactment of H.R. 1607 would have the effect of requiring the IRS and the Treasury to persuade Congress that it would be good tax policy and good economic policy to change the traditional tax treatment of TRAC leases as true leases for federal tax purposes.

What is a TRAC lease?

In a typical TRAC lease transaction, at the end of the lessees' use of a vehicle, the lessor takes the vehicle back from the lessee (who usually wants to be freed of the task of selling it), sells it on the open used car market at the best price obtainable, and then adjusts the rent by paying a refund to or collecting a deficiency from the lessee, to make up for any difference there is between the resale price actually realized from sale of the vehicle on the open market and the estimated or projected resale value of the vehicle that was used by the parties at the beginning of the lease in setting the amount of the rent payments. A typical vehicle TRAC lease transaction is NOT one in which the lessee is given an option to purchase the vehicle at the end of the lease term and certainly is NOT one in which the lessee is given an option to purchase the vehicle at a price that is nominal in relation to its actual market value at the end of the lease term. The TRAC vehicle lease was devised in the market place more than 30 years ago for the non-tax, business purpose of providing a financial incentive to the lessee user, who is the party to the lease transaction who is best able to control the cost of using and caring for the vehicle, to maintain the vehicle properly. That is done by providing that the lessee will bear the exact costs of the change in value of the vehicle that results during the lease term from his caring or failing to care for it.

Appendix D

Tax Equity and Fiscal Responsibility Act of 1982 [TEFRA]
(Public Law 97-248; 96 Stat. 324,
at pages 447 and 448)

SEC. 210. MOTOR VEHICLE OPERATING LEASES.

(a) IN GENERAL.—In the case of any qualified motor vehicle agreement, the fact that such agreement contains a terminal rental adjustment clause shall not be taken into account in determining whether such agreement is a lease.

(b) DEFINITIONS.—For purposes of this section—

(1) QUALIFIED MOTOR VEHICLE AGREEMENT.—The term "qualified motor vehicle agreement" means any agreement with respect to a motor vehicle (including a trailer)—

(A) which was entered into before—

(i) the enactment of any law, or

(ii) the publication by the Secretary of the Treasury or his delegate of any regulation,

which provides that any agreement with a terminal rental adjustment clause is not a lease,

(B) with respect to which the lessor under the agreement—

(i) is personally liable for the repayment of, or

(ii) has pledged property (but only to the extent of the net fair market value of the lessor's interest in such property), other than property subject to the agreement or property directly or indirectly financed by indebtedness secured by property subject to the agreement, as security for,

all amounts borrowed to finance the acquisition of property subject to the agreement, and

(C) with respect to which the lessee under the agreement uses the property subject to the agreement in a trade or business or for the production of income.

(2) TERMINAL RENTAL ADJUSTMENT CLAUSE.—The term "terminal rental adjustment clause" means a provision of an agreement which permits or requires the rental price to be adjusted upward or downward by reference to the amount realized by the lessor under the agreement upon sale or other disposition of such property.

Mr. **Wickham**. Let me say without even needing to examine committee reports, the statute is quite clear—there is no doubt about the matter—it applies to leases entered into after as well as before the enactment of section 210.

Chairman **Stark**. I disagree with the implication of your statement.

Mr. **Wickham**. If I may just add, Mr. Chairman, the bill, H.R. 8073, that had been introduced in 1980 to deal with this problem by then Chairman Ullman did, by its terms, apply only to leases entered into before a specified date in 1981. Thereafter, after his departure, the bill, the follow-on bill introduced by Mr. Holland, H.R. 6358, and later the bill by Mr. Gibbons, H.R. 3857, those bills are the foundation for what ultimately became section 210 of TEFRA.

Chairman **Stark**. No, they did not. There was no House-passed bill. It was in the Senate bill. It was written in conference.

Mr. **Wickham**. There were several House bills, Mr. Chairman.

Chairman **Stark**. But not in conference.

Mr. **Wickham**. Those House bills departed specifically——

Chairman **Stark**. You are not going to build a legislative record in this subcommittee on a conference that happened in 1982 on a provision in a Senate bill when there was no House bill.

Mr. **Wickham**. The principal sponsors of the House bill and the Senate bill departed from the prior bills to make them applicable to leases entered into after their enactment.

Chairman **Stark**. But there was no House bill, and that cannot stand unchallenged.

Mr. **Wickham**. It applied to contracts entered into after the date of enactment as well as before.

Chairman **Stark**. But that does not prevent the Treasury Department from issuing regulations addressing the legal effect of these clauses in contracts entered into after publication of such regulations. You know that, and I resent your trying to build a legislative record in this committee.

Mr. **Wickham**. Those we believe to be the correct facts, Mr. Chairman, as I have stated them.

Mr. **Schulze**. I have no questions, Mr. Chairman.

Mrs. **Kennelly**. No questions.

Chairman **Stark**. I thank the panel.

Mr. Hancock, Mr. Hutchison and Mr. Fantine, representing the Oil, Chemical & Atomic Workers International Union, to testify on H.R. 3030.

Mr. **Schulze**. Mr. Chairman, it gives me a great deal of pleasure to welcome these distinguished men before the committee, and we are ready to proceed with testimony.

Chairman **Stark**. Gentlemen, if you have prepared statements, they will appear in their entirety in the record. I can assure you at least for two of the members on the subcommittee your bill has a great deal of support, and any kind remarks you care to make about Mr. Schulze for his excellent legislative work in this matter will probably go a long way toward speeding this bill to a successful conclusion, but that is merely the Chair's opinion. I cannot speak for all of the members of the subcommittee.

You may proceed in any fashion in which you are comfortable to summarize your problem for us.

Mrs. KENNELLY. I would second that statement, Mr. Chairman.

Chairman STARK. I think you now have three members, so you are preaching to the choir, and you may do that in any fashion in which you are comfortable.

STATEMENT OF NOLAN HANCOCK, CITIZENSHIP-LEGISLATIVE DIRECTOR, OIL, CHEMICAL & ATOMIC WORKERS INTERNATIONAL UNION, ACCOMPANIED BY SAM HUTCHISON, PRESIDENT, LOCAL 8-901; AND DONALD FANTINE, FINANCIAL SECRETARY

Mr. HANCOCK. Thank you, Mr. Chairman.

My name is Nolan Hancock, and I am the legislative director of the Oil, Chemical & Atomic Workers International Union. With me today is Sam Hutchison, president of OCAW Local 8-901, and Don Fantine, the local union's financial secretary.

We appreciate very much the opportunity to appear before the committee today in support of H.R. 3030.

I would like to just summarize the problem that we have had over the years and the intent of this particular legislation, Mr. Chairman.

In 1973 there was a lockout by the company affecting 1,700 hourly employees. That lockout lasted for some 3 to 4 months. The dates are in the testimony.

During the lockout the employees submitted or made application for unemployment compensation benefits, and at the same time the company worked effectively to delay any payments of the unemployment compensation. Following that period of time there were court cases over a period of several years, finally going to the Pennsylvania Supreme Court, which did rule in favor of the union. The company then took the issue to the U.S. Supreme Court, and that was denied.

The problem, Mr. Chairman, in a nutshell, is that once the court cases had been cleared and the money was available and the checks were received, unfortunately, there was a new law which went into effect which allowed a 1979 taxation of those benefits that were really earned in 1973, and that is what we are here today to do, to address that problem, Mr. Chairman.

[The prepared statement follows:]

STATEMENT OF ROBERT S. GOSS, PRESIDENT, OIL, CHEMICAL & ATOMIC WORKERS INTERNATIONAL UNION, PRESENTED BY NOLAN HANCOCK

Mr. Chairman and Members of the Committee, my name is Nolan Hancock. I am the Citizenship-Legislative Director of the Oil, Chemical and Atomic Workers International Union. With me today are Sam Hutchison, President of Marcus Hook, Pennsylvania Local Union 8-901, and Donald Fantine, the Local's Financial Secretary.

I appreciate the opportunity to appear before you today in support of H.R. 3030, inasmuch as I believe this Committee is sincerely interested in addressing an injustice that has lingered for over 10 years.

In the spring of 1973, a local independent union experienced a most unfortunate work stoppage with its employer, the Sun Oil Company of Pennsylvania, when the Company unilaterally instituted major work rule changes in a manner and fashion that deliberately circumvented the collective bargaining agreement and the bargaining process. The stoppage began March 19th and would ultimately stretch into the summer months, ending in mid-July, some four months later.

I should note that it was during the period of the work stoppage that the members of this independent union, through a vote conducted by the National Labor Relations Board, voted overwhelmingly to affiliate with the Oil, Chemical and Atomic Workers International Union.

Although the work stoppage involved a legitimate bargaining issue, the Company nevertheless elected to extend its hostilities beyond the normal scope of collective bargaining.

Faced with a prolonged Company "lock-out" the employees filed for state unemployment compensation benefits. However, intent upon worsening the impact of its lock-out, the Company protested and effectively delayed the payment of any UI benefits.

However, approximately two months following the conclusion of the work stoppage a Referee ruled in favor of the Union, thereby affirming the employee's eligibility for unemployment benefits. But once again, by appealing to the Courts, the Company halted the payout of any unemployment benefits.

It was sometime before the Lower Courts ruled on the issue, but when the decision came down it was in favor of the Union 6 to 1. Unfortunately, the Company having lost the case received some consolation, in their view, in that the Court also placed a Restraining Order on the money.

In a persistent effort to resolve the issue the Union pursued the matter in nearly every Court in Pennsylvania, including the State Supreme Court in October of 1977.

The Union won there too, but the injunction on the payment of benefits remained. By this time the old adage, "Justice delayed is justice denied", was the only fair conclusion that could be drawn from these events.

But the long trail of litigation has not yet ended. The Sun Oil Company of Pennsylvania proceeded to appeal the case to the United States Supreme Court.

The case was never heard and the injunction was lifted. The money was coming, but something else was coming too. The employees after waiting for six years received their long awaited benefit checks in April of 1979. It would have been more fitting to the occasion had the checks all arrived on April 1st. For with them came unpalatable surprise—the checks, still bearing the date of 1973 would in effect be reduced even further in value as a result of a newly enacted tax law that took effect just 90 days earlier.

Under the new law, the Unemployment Compensation Tax Act of 1978, these employees found that their full year's income in 1979 made their unemployment benefits of 1973 taxable.

The compensation benefits in Pennsylvania in 1973 were $92.00 to $98.00 for a worker with a family. The benefits in 1979 for the same worker were upwards of $150.00. Not only did the locked out employees of Sun Oil have to wait six years to receive their benefits, which by 1979 had been eroded substantially by inflation, but they were now asked to assume an even higher tax burden.

There were approximately 1700 workers in 1973 affected by the stoppage. Needless to say, many of these workers were financially hurt by the stoppage and by the needless delaying UI benefits. Some were forced into debt and looked upon the payments of UI as a means of repaying their incurred financial obligations. We estimate that of the 1700 employees eligible for benefits only about 1400 ever received any. And of these approximately 75 percent ever received full benefits. The number in need of tax relief reduces even further since some of those receiving UI benefits were below the taxable income brackets established in the Revenue Act of 1978.

The workers of Sun Oil have a legitimate complaint, and I firmly believe that Congress had no intention to tax payments received long after they were earned, which is the case here today.

The measure, H.R. 3030, does not substantively change unemployment law, but actually deals with changing the effective year of personal income taxation on unemployment benefits.

I hope that you and your Committee will find this an appropriate time to resolve once and for all the injustice that these 1700 workers have experienced by acting favorably on H.R. 3030.

Thank you. I will be pleased to answer any questions that you may have.

INTERNAL REVENUE SERVICE,
DEPARTMENT OF THE TREASURY,
Washington, D.C., March 28, 1980.

Index No. 0085.00-00.
ID No. 23-7298164.
Corporation-Sun Oil Co.

OIL, CHEMICAL AND ATOMIC WORKERS,
International Union, Local 8-901,
Linwood, Pa.

DEAR SIR OR MADAM: This is in reply to a letter of November 30, 1979, and subsequent correspondence, submitted by your authorized representative, requesting a ruling concerning the taxability of unemployment benefits received by employees of Corporation in 1979 arising from a lock-out that occurred in 1973.

Approximately 1,700 employees of Corporation were engaged in a labor dispute with Corporation that resulted in a lock-out from March 19, 1973 to July 18, 1973. The employees involved were granted unemployment compensation benefits based on the lock-out. However, Corporation contested such employees' right to unemployment compensation preventing such amounts from being made available to the employees until 1979.

Section 112 of the Revenue Act of 1978 which added section 85 to the Internal Revenue Code states that such Code section shall apply to unemployment compensation payments made after December 31, 1978.

Section 85(a) of the Code provides that if the sum for the taxable year of the adjusted gross income of the taxpayer and the unemployment compensation exceeds the "base amount" gross income for the taxable year includes unemployment compensation in an amount equal to the lesser of:

(1) One-half of the amount of the excess of such sum over the base amount; or

(2) The amount of the unemployment compensation.

Section 85(b) of the Code defines base amount as:

(1) $20,000 (except as provided in (2) and (3) below);

(2) $25,000 in the case of a joint return under section 6013 of the Code; or

(3) Zero, in the case of a taxpayer who—

(A) Is married at the close of the taxable year (within the meaning of section 143 of the Code) but does not file a joint return for such year; and

(B) Does not live apart from his spouse at all times during the taxable year.

Based on the foregoing, we conclude that unemployment compensation benefits paid to the employees of Corporation after December 31, 1978, are includible in their gross incomes to the extent provided by section 85 of the Code.

In accordance with a power of attorney on file in this office, copies of this letter are being sent to your authorized representatives.

Sincerely yours,

ANTHONY MANZANARES, Jr.,
Chief, Individual Income Tax Branch.

Chairman STARK. Thank you, gentlemen, very much.

As I said, I know the committee chair looks favorably upon this. It is unfortunate that we have to put you to the trouble of legislating on matters that will seem eminently fair to people, and in a sense I do not like to see this committee have to become a court of last resort.

But Mr. Schulze has articulately pled your case, and despite the Treasury, who I have a hunch may oppose it, I find myself in support of your situation, and I hope we can see the legislation passed as soon as possible.

Mr. Schulze.

Mr. SCHULZE. Thank you, Mr. Chairman.

I would like to thank the gentlemen.

I have only one question. To bring out the fact that when the checks were received, weren't they actually dated 1973?

Mr. HANCOCK. That is correct.

Mr. SCHULZE. So the point is the checks had been there waiting, and it really just adds almost insult to injury for what has happened in this case. And I appreciate the chairman's indulgence, and I thank you gentlemen for traveling to present this testimony.

Chairman STARK. Does anyone want to add anything, gentlemen? Thank you very much.

Our final panel—we saved the best for last—Ed Cohen, counsel for the Investment Company Institute, and George Beatty, counsel to Bailard, Biehl & Kaiser.

I tell a little anecdote about Bailard, Biehl & Kaiser. I often say David Stockman got his entire economic education by reading "Sylvia Porter's Money Book," which is not quite true. The true story is that a friend of mine was a roommate of David's secretary, when he was on the Hill, and she had to help him balance his checkbook. She asked me for guidance, and I remembered Bailard, Biehl & Kaiser held seminars for our bankers in financial planning, and I got a copy of an excellent book they published on personal financial planning. The problem was it was too complex. David Stockman could not understand it. So my secretary went up to the bookstore and got "Sylvia Porter's Money Book" for $12.95. And that remains a true story today. We might have had a better budget outcome had he waded through the Bailard, Biehl & Kaiser tome.

As it stands, you were bettered by Sylvia Porter, and I hope that at least you tried, and the Government perhaps owes you a debt of gratitude.

You are here in support of Mrs. Kennelly's excellent legislation, H.R. 3529, and I am sure you have prepared statements. They will appear in the record in their entirety, and I would ask you to proceed in any brief fashion you care to again preach to the choir.

STATEMENT OF EDWIN S. COHEN, COUNSEL, ON BEHALF OF THE INVESTMENT COMPANY INSTITUTE

Mr. COHEN. Thank you, Mr. Chairman.

I am Edwin S. Cohen. I am a partner in the law firm of Covington & Burling here in Washington, and I appear before the subcommittee today on behalf of the Investment Company Institute. The Institute is a national association of the mutual fund industry.

The Institute strongly supports H.R. 3529, introduced by Mrs. Kennelly, which deals with three matters of concern to the mutual fund industry.

In the interest of time I will summarize this briefly.

The first of the three provisions relates to a matter that had been in the code for years that disqualifies a mutual fund if its outstanding stock is so closely held that it meets the criteria of a personal holding company.

Section 1 of the bill would eliminate the disqualification of the mutual fund that might occur simply because of stock being closely held. It would insure that in any event its income would be distributed and taxed currently to its shareholders because it would impose a 73-percent tax in effect, on any undistributed income.

Section 1(c) of the bill adds a further restriction that in the future any company that is a personal holding company and has not heretofore been governed by the regulated investment company provisions of the code could not elect to come under those provisions if it has accumulated earnings for prior years in which the company was not under those provisions.

The Treasury has stated to the committee, and Mr. Rollyson so stated earlier this afternoon, that it supports the bill, but it proposes that this latter provision be made applicable to all mutual funds whether or not they constitute personal holding companies.

We are concerned if the provision in its present form is extended to the entire universe of mutual funds, because we think there would be a number of serious practical problems.

In his statement Mr. Rollyson acknowledged that some changes would be in order in these provisions if they were so extended. We would be pleased to work with the Treasury and the committee staff to fashion a provision that could be made applicable to mutual funds that are not personal holding companies. But our suggestion is that the present bill be enacted in its present form and that the extension to other types of mutual funds be worked out and enacted in subsequent legislation.

The second provision in the bill deals only with the time for reporting for tax purposes discount accrued on Government obligations. It permits a mutual fund to report that income as the discount is earned rather than requiring that the reporting be postponed until the obligation is paid at maturity or sold.

We understand that the Treasury also supports this provision.

The last provision in the bill clarifies the situation that has developed because two different amendments to the same section of the Internal Revenue Code were made in the last Congress. An identical clarifying provision has now already been reported out by the full committee as a part of the pending Tax Reform Act of 1983.

Mr. Chairman, that concludes my statement.

Chairman STARK. I think we reported it twice.

Mr. COHEN. Twice? Well, we were not sure which of those bills would make it through the quickest.

Chairman STARK. Mr. Beatty.

[The prepared statement follows:]

STATEMENT OF EDWIN S. COHEN ON BEHALF OF THE INVESTMENT COMPANY INSTITUTE

My name is Edwin S. Cohen. I am a partner in the law firm of Covington & Burling, Washington, D.C., and I appear before the Subcommittee today on behalf of the Investment Company Institute.

The Institute is the national association of the mutual fund industry. Its membership includes more than 900 open-end investment companies (referred to generally as "mutual funds"), their investment advisers and principal underwriters. The Institute's mutual fund members have assets of more than $260 billion and have approximately 16 million shareholder accounts.

The Institute strongly supports H.R. 3529. This bill would alleviate three sets of technical federal income tax problems that currently concern the mutual fund industry: (1) the risk that a mutual fund may be disqualified as a regulated investment company, even without its knowledge, if it should happen to meet the stock ownership requirements of a personal holding company during the last half of its taxable year; (2) the possibility of perverse and unintended tax consequences if mutual funds are required for tax purposes to postpone until a later year discount earned on short-term Government obligations that they ratably accrue for accounting purposes; and (3) the uncertainty regarding the status of section 103(m) of the Internal Revenue Code (the "Code") that resulted from the sequence in which the President signed two 1982 bills amending that section. Each of H.R. 3529's three sections is devoted to one of these concerns.

1. PERSONAL HOLDING COMPANY STATUS (SECTION 1 OF THE BILL)

At present section 851(a) of the Code completely disqualifies a mutual fund from the "flow-through" treatment accorded regulated investment companies under subchapter M of the Code if the company falls within the criteria of a personal holding company. A mutual fund will meet these criteria if 50 percent or more of its stock is owned by five or fewer persons at any time during the last half of its taxable year. For this purpose certain employee benefit trusts are treated as a single person and family members and partners are treated as a single person under the "attribution" rules of section 544(a).

Because a mutual fund is generally required by the Investment Company Act of 1940 to have 100 or more shareholders, or to be offering its shares publicly, personal holding company status is not normally a significant risk. Because of the employee trust rule and the attribution rules, however, it is possible for this problem to arise when a mutual fund is first organized or is relatively small in size.

As a result of becoming a personal holding company, a disqualified mutual fund would be subject to full corporate taxation on all of its income, even though that income had been fully distributed and taxed to the company's shareholders. Section 1(a) and (b) of H.R. 3529 would remove the disqualifying reference to personal holding company status now contained in section 851(a) but would, in the case of a mutual fund that does qualify as a personal holding company, increase the rate of regular corporate tax on any undistributed income of the mutual fund under section 852(b)(1) to the maximum corporate rate of 46 percent. The lower graduated rates for taxable corporate income below $100,000 would be inapplicable, and under Code section 852(b)(2)(c) no dividends received deduction would be available. Since the personal holding company tax of 50 percent would also apply to the remaining 54 percent of any undistributed income, the total tax burden on any undistributed income would be 73 percent.

The current prohibition against mutual funds being personal holding companies was designed to discourage the accumulation of passive income by entities subject to a significantly lower tax rate than the maximum rate for individuals and to restrict "flow-through" tax treatment to entities whose stock is widely held. The first of these objectives would be satisfied under the provision in H.R. 3529 that effectively subjects any undistributed income of a mutual fund that is also a personal holding company to a 73 percent tax. The second objective has been superseded as a matter of tax policy by the recent amendments to subchapter S of the Code that now permit flow-through tax treatment for investment income in the case of entities whose stock is closely held.

In order fully to qualify for subchapter C treatment, however, a company having primarily investment income may not have accumulated earnings and profits from years in which it was not governed by the provisions of that subchapter. For consistency, therefore, section 1(c) of the bill provides that hereafter a mutual fund that is also a personal holding company cannot qualify for subchapter M status if it has earnings and profits accumulated in years when it was not subject to subchapter M. Thus, under this provision a closely held company that has operated an active business could not sell its productive assets, invest the proceeds in securities and qualify for flow-through tax treatment under either subchapter S or subchapter M unless it first distributed to its shareholders all of its accumulated earnings and profits.

We note that the Treasury Department, in a letter dated October 4, 1983 to Mrs. Kennelly, who introduced H.R. 3529, stated that it does not oppose the bill but expressed a preference for broadening the application of the restrictions in section 1(c) of the bill to a larger group of companies. Section 1 of the bill applies only to regulated investment companies that meet the criteria for personal holding companies. Accordingly, the restrictions in section 1(c) of the bill are confined to companies that are closely held and would be personal holding companies. The Treasury suggests that the restrictions in section 1(c) be made applicable to all regulated investment companies, even to those that would not be personal holding companies.

We are concerned that broadening the application of section 1(c) of the bill could have a serious unwarranted effect on a mutual fund that might inadvertently fail in any year to meet one of the various requirements in subchapter M for qualification as a regulated investment company and might be found to have failed to distribute all of its earnings or profits for that year. A failure to have distributed one dollar of earnings might prevent the company from qualifying as a regulated investment company in subsequent years. While the chance of this result occurring in a mutual fund which also unexpectedly turned out to be a personal holding company is negligible, the possibility of its occurring in the entire universe of mutual funds is significant enough to cause serious concern.

Our suggestion would be to leave the restrictions in section 1(c) of H.R. 3529 in their present form, applicable only to mutual funds that are closely held. We would be pleased to work with the Treasury and the Committee staffs to develop a provision that would deal similarly with widely held mutual funds without the possibility of serious adverse consequences that a mere extension of section 1(c) of the pending bill would entail. Such a provision could be adopted in subsequent legislation. In any event, if the provision is to be broadened in some fashion, the "grandfathering" date of June 30, 1983 in subsection 1(c) should be changed to December 31, 1983.

2. ACCRUAL OF DISCOUNT ON SHORT-TERM GOVERNMENT OBLIGATIONS (SECTION 2 OF THE BILL)

Section 2 of H.R. 3529 would permit mutual funds to accrue discount on short-term Government obligations on a ratable basis for tax purposes rather than defer reporting that discount until the obligations are paid at maturity, sold or otherwise disposed of, as is apparently required under section 454(b) of the Code. These mutual funds accrue on their books daily the interest or discount on the debt obligations they hold, as the SEC and generally accepted accounting principles require them to do, and distribute that interest to their shareholders at frequent intervals, typically monthly. When these mutual funds hold short-term Government obligations issued at a discount, therefore, as many of them in fact do, they amortize that discount and accrue it into income ratably on a daily basis over the period they hold the obligations.

Because section 454(b) literally requires deferral of discount on such obligations for tax purposes, a money market fund that holds these obligations will, at the end of each taxable year, have accrued as book income and paid out to its shareholders amounts of discount that is not to be reported as taxable income until the following year when the obligation is paid or is sold. This could create unintended tax problems for the mutual fund, which under subchapter M should pay out currently its net income, since the amount of the discount may be paid out to shareholders in the taxable year before it is to be reported by the mutual fund for tax purposes.

The legislative history of section 454(b), which was adopted in 1941, clearly indicates that the sole purpose of that provision was to simplify the tax treatment of short-term Government obligations. For money market mutual funds, however, which did not even exist in 1941, that provision produces complexity rather than simplicity and a possibility of unintended tax consequences. Section 2 of H.R. 3529 would eliminate this situation by providing simply that mutual funds can elect to make section 454(b) inapplicable so that they can accrue discount on short-term Government obligations on a ratable basis for tax purposes as they do for book purposes.

3. CLARIFICATION OF SECTION 103(m) OF CODE (SECTION 3 OF THE BILL)

Section 3 of the bill would remove the uncertainty surrounding the proper text of section 103(m) of the Code that resulted from the Presdient's having signed two bills that amended that section in the reverse order from which they were passed by Congress.

On December 22, 1982, Congress passed Public Law 97-473, part of which substituted a new list of cross references in section 103(m) of the Code for the one then contained therein. On December 23, 1982, Congress passed Public Law 97-424, the Highway Revenue Act of 1982, which redesignated section 103(m) as section 103(n) and added a new section 103(m) to provide that obligations the interest on which has previously been exempt from federal income tax under laws other than the Code will be deemed to be obligations described in section 103(a) of the Code. One of the objectives of this new provision was to make such obligations eligible for the flow-through treatment accorded tax exempt interest of regulated investment companies under section 852(b)(5) of the Code.

President Reagan, however, signed Public Law 97-424 before Public Law 97-473. If these laws were given effect in the order in which they were signed by the President, the revised list of cross references in Public Law 97-473 would replace the tax exempt obligations provision in Public Law 97-424 that Congress intended to enact. Section 3 of H.R. 3529 would simply assure that section 103(m) will read as if these two laws had been signed by the President in the same order in which they were passed by Congress.

The pending Tax Reform Act of 1983 (H.R. 4170), reported by the Committee on Ways and Means on October 21, 1983, contains in section 622(b) a provision identical to Section 3 of H.R. 3529.

STATEMENT OF GEORGE W. BEATTY, COUNSEL, BAILARD, BIEHL & KAISER, INC.

Mr. **Beatty**. I am George Beatty of the Washington law firm of Lee, Toomey & Kent, appearing here on behalf of Bailard, Biehl & Kaiser.

Since I am last and I hope not least, I will simply say we strongly support H.R. 3529 and rely on the written statement we have already submitted in support of our position.

[The prepared statement follows:]

Statement of George W. Beatty

Mr. Chairman and Members of the Subcommittee, on behalf of Bailard, Biehl & Kaiser, Inc., an employee-owned investment counseling firm, I thank you for this opportunity to comment on H.R. 3529. Although Bailard, Biehl and Kaiser supports all three sections of H.R. 3529, my remarks will be confined to section 1 of the bill.

COMMENTS ON SECTIONS 1(a) AND (b)

Section 1(a) of H.R. 3529 would prevent a mutual fund from losing its flow-through tax treatment under the RIC provisions merely because it met the stock ownership requirement of a personal holding company ("PHC") during the last half of its taxable year. Instead, section 1(b) would subject a RIC which is a PHC to tax at the highest corporate tax rate on its undistributed earnings.

Sections 1 (a) and (b) would provide a much-needed technical revision and simplification of the RIC provisions. In 1936, the original purpose of the PHC prohibition was to limit the flow-through treatment provided by the RIC provisions to widely-held companies. Unfortunately, subsequent changes in the complex PHC stock ownership rules that had nothing to do with RICs can cause harsh results. An illustration of the technical trap caused by the PHC provision is Rev. Rul. 82-107, 1982-1 C.B. 103, in which the PHC stock ownership partner-attribution rules prevented a regulated mutual fund from qualifying as a RIC because some of the shareholders of the fund invested in syndicated limited partnerships. Indeed, if any number of persons owning 51 percent of a mutual fund's stock have limited partnership interests of any size in any of five totally unrelated limited partnerships, the PHC constructive ownership rules will prevent the mutual fund from qualifying as a RIC. Countless other fortuitous combinations will produce the same results. This clearly is unintended because the shareholders of a regulated mutual fund usually do not even know each other.

As indicated by the Treasury Department letters dated June 22, 1983 and October 4, 1983 which are attached to this Statement as Exhibit A, the Treasury Department has recognized this specific technical problem, and it supports corrective legislation.

In addition, the original function of the PHC prohibition—to limit flow-through treatment of investment income to widely-held mutual funds—has been largely eroded. Since S corporations need not be widely held to benefit from flow-through treatment of their investment income, there appears to be no reason why a PHC should be treated differently. At the same time, taxation of the undistributed income of a RIC which is a PHC at the highest corporate tax rate, coupled with the PHC tax to which a RIC also would be subject, would discourage any use of RICs to shelter passive income at corporate tax rates.

Thus, sections 1 (a) and (b) of H.R. 3529 would update the PHC provisions to reflect what appears to be Congress' current and continuing intent.

COMMENTS ON SECTION 1(C)

Section 1(c) of H.R. 3529 would prevent a PHC from qualifying as a RIC if it has accumulated earnings and profits from a prior taxable year in which it was not a RIC, unless the mutual fund has qualified as a RIC for all taxable years ending on or after June 30, 1983.

Bailard, Biehl & Kaiser supports this section as well.

CONCLUSION

In conclusion, H.R. 3529 would correct and simplify important RIC provisions yet prevent abuse of PHCs. It's a much-needed bill.

Exhibit A

Department of the Treasury,
Washington, D.C., June 22, 1983.

Hon. Fortney H. Stark,
House of Representatives,
Washington, D.C.

Dear Pete: Thank you very much for your December 17, 1982 letter relating to a proposed amendment to the Internal Revenue Code to resolve a tax problem resulting from the application of the constructive ownership rules to Regulated Investment Companies ("RICS").

Under present law, a RIC with large numbers of individual shareholders may lose its RIC status and become taxable as a regular corporation if more than 50 percent of its stock is owned actually or constructively by 5 or fewer individuals. A RIC shareholder is considered constructively to own the RIC shares owned by his partners in any partnership. Therefore, if sufficient RIC shareholders have partnership investments in common, the RIC may become disqualified because the stock ownership of the RIC would be considered to be excessively concentrated in the hands of a few individuals. See Code sections 544(a)(2) and 851(a).

Treasury believes that the historical purpose of the RIC provisions—to permit small investors to obtain the benefits of investment diversification and professional management through a widely-held investment vehicle taxed in a manner comparable to direct ownership of securities—is not served by denying RIC status to an investment company with a large number of unrelated individual shareholders merely because some of them have passive limited partnership investments in common.

Accordingly, the Treasury Department supports the proposed amendment to Code section 542(c) that is enclosed hereto as an exhibit. The amendment would allow a mutual fund to preserve its RIC status if (i) it has at least 100 actual shareholders who are unrelated individuals (or are certain specified organizations), and (ii) no more than 50 percent in value of the shares of the RIC is owned directly or indirectly by five or fewer related individuals. Stock ownership would be determined by applying the existing attribution rules of Code section 544, except that stock owned by a limited partner would not be attributed to another partner.

In addition, it should be noted that recent changes have been made in the law applicable to passive investment income of "S Corporations" under the Subchapter S Revision Act of 1982 (Pub. L. 97-354). These changes permit certain corporations electing under Subchapter S to earned unlimited passive investment income without loss of their flow-through tax status, but only if they have no Subchapter C earnings and profits. In light of these changes, Treasury would be interested in reexamining the policy rationale of the rule which denies flow-through treatment to RICs whose share ownership is concentrated in the hands of a few individuals and whose income is predominantly passive investment income, given that closely held S Corporations are afforded flow-through treatment for their passive investment income.

Thank you for your interest in this matter.

Sincerely,

John E. Chapoton,
Assistant Secretary (Tax Policy).

Enclosure.

PROPOSED AMENDMENT TO IRC SECTION 542(C)

Amend § 542(c) by deleting the word "and" at the end of paragraph (8); substituting "; and" for the period at the end of paragraph (9); and adding a new paragraph reading as follows:

> "(10) a corporation otherwise qualifying as a regulated investment company within the meaning of section 851(a) if at all times during the last half of such corporation's taxable year—
>
> > (A) such corporation has at least 100 shareholders (determined without regard to section 544) who are individuals (or organizations treated as individuals by subsection (a)(2)); and
> >
> > (B) no more than 50 percent in value of such corporation's outstanding stock is owned, directly or indirectly by or for not more than 5 individuals (after applying secton 544, except that for purposes of this paragraph the term "partner" in section 544(a)(2) shall not include a limited partner in a limited partnership)."

Department of the Treasury,
Washington, D.C., October 4, 1983.

Hon. Barbara B. Kennelly,
House of Representatives,
Washington, D.C.

Dear Mrs. Kennelly: Thank you for your August 16, 1983 letter to Secretary Regan requesting Treasury's comments on H.R. 3529, a bill which you introduced to make certain amendments to the provisions of the Internal Revenue Code relating to regulated investment companies ("RICs").

Treasury does not oppose sections 2 and 3 of H.R. 3529. Treasury also does not oppose section 1 of the bill, although we believe that section 1(c) should be given broader application than it has under the bill as presently written. Our comments on each section are as follows:

SECTION 1

Section 1(a) would remove the prohibition against a personal holding company ("PHC") electing to be a RIC (the "PHC prohibition"). Section 1(b) would subject RICs that are PHCs to tax at the highest corporate tax rate on their undistributed earnings. Section 1(c) prevents a PHC from qualifying as a RIC for tax purposes if it has accumulated earnings and profits from a prior taxable year in which it was not a RIC. The limitation of section 1(c) would not apply to any RIC that has qualified for tax purposes for all taxable years ending on or after June 30, 1983.

Treasury does not oppose the thrust of section 1. The principal objective of section 1 is to remove the PHC prohibition from the RIC statute. The prohibition serves little purpose, but imposes significant administrative burdens on some RICs by requiring them to monitor their possible PHC status.

The existing PHC prohibition apparently was intended to serve two functions: to insure that flow-through tax treatment of investment income is limited to widely held investment companies, and to prevent use of a RIC as an "incorporated pocketbook" that earns passive income taxed at the corporate level, rather than to the shareholders. With respect to the first of these purposes, however, it is important to recognize that since enactment of the Subchapter S Revision Act of 1982, qualifying S corporations (which are closely held) generally are allowed flow-through tax treatment for their investment income without limitation as long as they have no accumulated earnings and profits from years in which they were Subchapter C corporations. Since S corporations need not be widely held to benefit from flow-through taxation of their investment income, we know of no reason why a similarly situated RIC (another form of flow-through entity) should be treated differently.

With respect to the second purpose of the PHC prohibition, section 1(b) of your bill imposes a tax at the highest corporate tax rate (46 percent) on a RIC's undistributed earnings if it is a PHC. This tax, in addition to the PHC tax to which such a RIC also would be subject, is adequate to discourage use of RICs to avoid tax on their shareholders with respect to undistributed passive investment income.

Section 1(c) would prohibit a PHC from becoming a RIC if it has accumulated earnings and profits from a non-RIC year. Section 1(c) reflects a concern similar to that which motivated Congress to include in the Subchapter S Revision Act special limitations applicable to S corporations with Subchapter C accumulated earnings and profits. The problem in these cases is that a C corporation with an active business and substantial accumulated earnings might discontinue its business, sell its business assets, and invest the proceeds in passive investments. If the corporation is able to avoid corporate tax on its investment income by electing to be a RIC or an S corporation, there would be little reason for it to pay dividends out of its accumulated earnings from the discontinued business, or to liquidate the corporation (and subject the shareholders to tax on the liquidation). Allowance of a Subchapter S or RIC election would, as your statement accompanying the introduction of H.R. 3529 indicates, be a "potential loophole."

We believe that the policy of section 1(c) is sound, but that it logically cannot be limited to RICs that are PHCs. Any corporation (whether or not a PHC) that has accumulated earnings and profits could obtain undue tax benefits from a RIC election. Treasury believes that section 1(c) should be extended to cover all corporations desiring to become RICs, not just PHCs that seek RIC status. We would not object to grandfathering all existing RICs from this rule.

In summary, Treasury does not oppose section 1(a) and 1(b) of the bill. However, Treasury believes that section 1(c) should be extended to cover all corporations desiring to become RICs (not just PHCs).

SECTION 2

Section 2 would permit RICs to elect to compute their taxable income with respect to short term government obligations issued at a discount without regard to Code section 454(b). Code section 454(b) states that discount on certain short term government obligations having a maturity of 1 year or less accrues for tax purposes when the obligations are paid at maturity, sold, or otherwise disposed of. Treasury does not oppose section 2.

We understand that money market RICs accrue interest on debt obligations daily for bookkeeping and SEC purposes, and that discount income on short term government obligations issued at a discount is accrued ratably each day the obligations are held by the RIC. The disparity between the accounting treatment of this discount income (daily accrual) and the Code section 454(b) treatment (accrual on the date of maturity or sale) can create serious tax problems for a RIC that has made distributions of income based on its book income, rather than on its income determined under the rules of Code section 454(b).

The legislative history of Code section 454(b) indicates that it was enacted to relieve taxpayers of certain burdensome calculations that would be necessary if the discount on short-term government bonds were accrued on a daily basis. However, RICs must make these daily calculations for book purposes. We believe that section 454(b) was enacted for practical reasons, rather than because of any defect in the rules relating to daily accrual of discount on short-term government bonds. Thus, for a RIC that would not be burdened by the daily accrual method, Treasury does not oppose providing an election to use the daily accrual method for the class of obligations subject to Code section 454(b).

SECTION 3

Section 3 would clarify that the order in which the President signed two bills enacted by Congress in 1982 is not to be construed as having resulted in a repeal of Code section 103(m) (relating to obligations exempt from tax under provisions of law other than the Internal Revenue Code). Section 3 is merely a clarification of Congressional intent. It is clear that Congress in fact did not intend to repeal Code section 103(m) by virtue of anything contained in the second of the two bills signed by the President. Accordingly, Treasury does not oppose section 3 of H.R. 3529.

Sincerely,

JOHN E. CHAPOTON,
Assistant Secretary (Tax Policy).

Chairman **STARK**. Gentlemen, thank you.

And without objection, that concludes today's hearing. Thank you all.

[Whereupon, at 5:23 p.m., the hearing was adjourned.]

APPENDIX

The text, summary, and written comments received on bills which are the subject of the hearings follow. The bills are arranged in numerical order.

98TH CONGRESS
1ST SESSION

H. R. 677

To provide that subtitles A and C of the Internal Revenue Code of 1954 shall be applied without regard to the value of lodging located in the proximity of an educational institution and furnished by such institution to its employees for taxable years or periods beginning before January 1, 1984.

IN THE HOUSE OF REPRESENTATIVES

JANUARY 6, 1983

Mr. SHANNON (for himself and Mr. CONABLE) introduced the following bill; which was referred to the Committee on Ways and Means

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A BILL

To provide that subtitles A and C of the Internal Revenue Code of 1954 shall be applied without regard to the value of lodging located in the proximity of an educational institution and furnished by such institution to its employees for taxable years or periods beginning before January 1, 1984.

Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled,

(a) IN GENERAL.—For taxable years or periods beginning before January 1, 1984, subtitles A and C of the Internal Revenue Code shall be applied without regard to the value of qualified campus lodging furnished by, or on behalf of, any educational institution described in section

170(b)(1)(A)(ii) of such Code to any employee of such institution or to any spouse or dependent (within the meaning of section 152 of such Code) of such employee.

(b) QUALIFIED CAMPUS LODGING.—

(1) IN GENERAL.—For purposes of this section, the term "qualified campus lodging" means lodging—

(A) which is provided by an educational institution described in section 170(b)(1)(A)(ii),

(B) which is located on a campus of, or in the proximity of, such institution, and

(C) for which such institution receives a reasonable rent which is not less than the necessary direct costs paid or incurred by such institution in providing such lodging.

(2) REASONABLE RENT.—

(A) LESS THAN FAIR RENTAL VALUE.—A rent shall not be precluded from being treated as a reasonable rent solely because of the fact that such rent is less than the fair rental value of the lodging provided.

(B) FACTORS.—The determination of whether any rent is a reasonable rent shall take into account such factors as the necessary direct costs of such institution furnishing the lodging, the value of the lodging to the employee to whom the lodging is furnished, and any educational purposes of the institution in furnishing such lodging.

(c) SPECIAL RULE WHERE RENT IS LESS THAN DIRECT COSTS.—In any case in which lodging would be treated as qualified campus lodging but for the fact that the rent received was less than the necessary direct costs described in subsection (b)(1)(C), only the excess of—

(1) the amount of such necessary direct costs, over

(2) the rent received with respect to such lodging,

shall be taken into account for purposes of subtitles A and C of the Internal Revenue Code for taxable years or periods beginning before January 1, 1984.

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Summary and Description

PRESENT LAW

Present law (Code sec. 19) excludes from an employee's gross income the value of lodging provided by the employer if (1) the lodging is furnished for the convenience of the employer, (2) the lodging is on the business premises of the employer, and (3) the employee is required to accept the lodging as a condition of employment. Several court decisions have held that on-campus housing furnished ato faculty or other employees by an educational institution did not satisfy the section 119 requirements, and hence that the fair rental value of the housing (less any amounts paid for the housing by the employee) was includible in the employee's gross income and constituted wages for income tax withholding and employment tax purposes.[1]

EXPLANATION OF THE BILL

The bill would provide an exclusion, for income and employment tax purposes, for the value of qualified campus lodging furnished by, or on behalf of, an educational institution (within the meaning of sec. 170(b)(1)(A)(ii))[2] for taxable years or periods beginning before 1984. The exclusion would apply to the value of such lodging furnished to any employee of the educational institution (or to the employee's spouse or dependents), including non-faculty employees.

The bill would apply only if (1) the employer-furnished lodging is located on a campus of, or in the proximity of, the educational institution and (2) the employee pays a reasonable rent that is not less than the necessary direct costs paid or incurred by the institution in providing the lodging.

Under the bill, the determination of whether a rental amount is reasonable would take into account factors such as the necessary direct costs of the institution furnishing the lodging, the value of the lodging to the employee to whom the lodging is furnished, and any educational purposes of the institution in furnishing the lodging. The bill would provide that a rent is not to be considered unreasonable solely because the rent is less than the fair rental value of the lodging.

Under the bill, in any case in which lodging provided to an employee (or the employee's spouse or dependents) would constitute qualified campus lodging but for the fact that the rent received is less than the necessary direct costs of the educational institution, only the excess of (1) the amount of the necessary direct costs over (2) the rent paid with respect to the lodging would be includible in the employee's gross income and would constitute wages for income tax withholding and FICA and FUTA tax purposes.

EFFECTIVE DATE

The provisions of the bill would apply retroactively for taxable years or periods beginning before January 1, 1984.

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[1] *Bob Jones Univ.* v. *U.S.*, 670 F.2d 167 (Ct. Cl. 1982); *Goldsboro Christian Schools, Inc.* v. *U.S.*, 79-1 CCH USTC para. 9266, E.D.N.C. 1978 (value of lodging furnished to faculty constitutes wages subject to income tax, FICA, and FUTA withholding, in light of "long and consistent history of regulations and rulings, expressly and explicitly applying withholding taxes to lodging not furnished for the employer's convenience***"), *aff'g* order entered in *Goldsboro Christian Schools, Inc.* v. *U.S.*, 436 F. supp. 1314 (E.D.N.C. 1977), *aff'd per curiam* in unpublished opinion (4th Cir. 1981), *aff'd* 103 S. Ct. 2017 (1983)); *Winchell* v. *U.S.*, 564 F. Supp. 131 (D. Neb. 1983) (value of campus home taxed to college president); and *Coulbourn H. Tyler*, 44 CCH Tax Ct. Mem. 1221 (1982).

Public Law 98-63, making supplemental appropriations for fiscal year 1983, prohibited the Internal Revenue Service from using any funds appropriated under that statute "to enforce any ruling which would subject to tax under subtitles A and C of the Internal Revenue Code of 1954 the value of campus lodging furnished by, or on behalf of, any educational institution described in section 170(b)(1)(A)(ii) of such Code to any employee of such institution or any spouse or dependent (within the meaning of section 152 of such Code) of such employee, or to conduct any other activity with respect to the assessment or collection of any such tax on such value".

[2] An educational organization is described in sec. 170(b)(1)(A)(ii) "if its primary function is the presentation of formal instruction and it normally maintains a regular faculty and curriculum and normally has a regularly enrolled body of pupils or students in attendance at the place where its educational activities are regularly carried on. The term includes institutions such as primary, secondary, preparatory, or high schools, and colleges and universities," and includes both public and private schools (Treas. Reg. sec. 1.170A-9(b)(1)).

I

98TH CONGRESS
1ST SESSION

H. R. 699

To amend the Internal Revenue Code of 1954 with respect to the tax treatment of certain conversions of residential rental property into condominium units.

IN THE HOUSE OF REPRESENTATIVES

JANUARY 6, 1983

Mr. STARK (for himself and Mr. ARCHER) introduced the following bill; which was referred to the Committee on Ways and Means

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A BILL

To amend the Internal Revenue Code of 1954 with respect to the tax treatment of certain conversions of residential rental property into condominium units.

Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled, That (a) part IV of subchapter P of chapter 1 of the Internal Revenue Code of 1954 (relating to special rules for determining capital gains and losses) is amended by adding at the end thereof the following new section:

"SEC. 1257. ELECTION TO TREAT CERTAIN CONVERSIONS INTO CONDOMINIUM UNITS AS SALES.

"(a) GENERAL RULE.—For purposes of this title, at the election of the taxpayer—

"(1) the conversion of any qualified residential real property into condominium units shall be treated as a sale of such property for an amount equal to its fair market value as residential rental property,

"(2) any gain determined under section (a)(1) shall be capital gain. Any additional gain determined upon disposition of the dwelling units shall be ordinary income. All such gain shall be recognized as from time to time realized in the same proportion that gain in the first sentence bears to the gain in the second sentence, and

"(3) expenditures incurred in connection with improvements in the dwelling units while held by the taxpayer in anticipation of their sale, or pursuant to a contract of sale between the taxpayer and the buyer shall be treated as reducing that portion of the gain treated as ordinary income.

"(b) QUALIFIED RESIDENTIAL REAL PROPERTY.—For purposes of this section, the term 'qualified residential real property' means any real property—

"(1) which was residential rental property (as defined in section 167(j)(2)(B)) in the hands of the taxpayer, and

"(2) which, except in the case of property acquired by inheritance or devise, was residential real property held by the taxpayer for at least 5 continuous years immediately before the conversion into condominium units.

"(c) FAIR MARKET VALUE DETERMINATIONS.—For purposes of this section, the fair market value of any qualified residential real property shall be determined as residential rental property immediately before the conversion and without regard to any substantial improvement made in anticipation of the conversion.

"(d) SPECIAL RULES.—

"(1) SECTION APPLIES ONLY WHERE GAIN RESULTS.—Subsection (a)(1) shall not apply if the application of such subsection would result in the recognition of a loss.

"(2) BASIS ADJUSTMENTS.—The Secretary shall prescribe such regulations as he may deem necessary to provide for adjustments in basis to reflect gain recognized under this section.

"(3) ELECTION.—An election under subsection (a) shall be made at such time and in such manner as the Secretary shall by regulations prescribe. Such an election, once made, may be revoked only with the consent of the Secretary."

(b) The table of sections for part IV of subchapter P of chapter 1 of such Code is amended by adding at the end thereof the following new item:

"Sec. 1257. Election to treat certain conversions into condominium units as sales."

(c) The amendments made by this section shall apply to conversions after the date of the enactment of this Act in taxable years ending after such date.

○

SUMMARY AND DESCRIPTION

PRESENT LAW

Under present law, gain or loss on the sale or exchange of a capital asset is treated as capital gain or loss. If the capital asset is held for more than one year, the resultant capital gain or loss is long-term capital gain or loss. Long-term capital gain is taxed at preferential rates.

In general, a capital asset is any property owned by a taxpayer, whether or not connected with his trade or business other than certain exceptions. Under one of those exceptions, an asset is not a capital asset if it is stock in trade of the taxpayer or other property of a kind which would properly be included in inventory of the taxpayer if on hand at the close of the taxable year, or is property held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business (Code sec. 1221(1)).

The question of whether or not property is held primarily for sale to customers in the ordinary course of a trade or business is one of fact. Among the factors considered in making this determination are the intent of the owner (whether the property was acquired or was held for investment or for subdivision and resale in the ordinary course of a trade or business); whether the sale was merely the liquidation of an investment; whether there are sales activities such as development and improvement work on the property; whether there is promotional activity such as advertising, the use of salesmen, or payment of commissions; whether the proceeds are reinvested in like property; and whether the owner is a dealer in the trade or business.

Present law also provides a special rule for determining whether or not a taxpayer (other than dealers in real estate but including corporations in certain cases) will be treated as holding real property for sale in the ordinary course of a trade or business (section 1237). If the requirements of section 1237 are met, gain from the sale or exchange of the first 5 parcels in the tract is treated as capital gain. In addition, only five percent of the gain on the sale or exchange of the sixth and succeeding parcels is treated as ordinary income.

In order to be eligible for the special treatment provided by section 1237, the taxpayer must not have held the tract or any parcel thereof for sale in the ordinary course of a trade or business (and must not hold other real estate for sale to customers in the ordinary course of a trade or business in the year of the sale under sec. 1237). In addition, the taxpayer must not have made "substantial" improvements (other than "necessary" improvements and certain marketing expenditures) to the tract which substantially enhance the value of the lot or parcel sold. Finally, the taxpayer must have held the parcel sold for 5 years unless acquired by inheritance or devise.

The Internal Revenue Service has held that section 1237 of the Code does not apply to the conversion of rental units in an apartment building to condominiums for resale to the public (Rev. Rul. 80-216, 1980-2 C.B. 239). However, the fact that section 1237 does not apply to such a conversion does not imply that the resale of such condominiums must necessarily be treated as ordinary income.[1]

EXPLANATION OF THE BILL

Under the bill, a taxpayer could elect to treat the conversion of any qualified residential rental property into condominium units as a sale of the property, but only for purposes of computing the proportion of the gain to be recognized as capital gain when the units are disposed of and the gain is realized.[2] In order to determine the amount of the capital gain, the property would be treated as having been sold for an amount equal to its fair market value, as residential property, immediately before the conversion. Any substantial improvement to the property, made in anticipation of the conversion, would not be taken into account in determining the fair market value.

At the time each dwelling unit is sold, a portion of the total gain realized would be recognized as capital gain; the remaining portion would be recognized as ordinary income. The portion of the gain from the sale of an individual unit that would be treated as capital gain would be equal to the ratio of the gain at the time of the conversion of the whole complex bears to the total gain from the sale of all individual units.

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[1] See, IRA Letter Ruling 8204031, October 27, 1981.

[2] It is unclear from the bill whether the property would be treated as sold only for purposes of computing the amount of capital gain to be recognized when the gain is, in fact, realized, or whether the unrealized capital gain would be recognized at the time of the conversion. It is our understanding that the intent of the bill is as described in this explanation.

Qualified residential property would be defined as property which the taxpayer holds as residential rental property and which the taxpayer held as residential property for at least 5 continuous years immediately before the conversion. The 5-year rule would not apply to property acquired by inheritance or devise.

No loss would be recognized if treating the conversion of the property as a sale under the provisions of this bill would result in a loss.

EFFECTIVE DATE

The bill would apply to conversions after the date of enactment in taxable years ending after such date.

REVENUE EFFECT

The revenue effect of this bill is not available at this time.

STATEMENT OF ALAN J. B. ARONSOHN, ESQ., TAX COUNSEL, NATIONAL REALITY COMMITTEE, INC.

The National Realty Committee, Inc., is a nonprofit business league whose membership includes owners, operators, financiers, and developers of all types of real estate throughout the United States.

The National Realty Committee respectfully submits the following comments with respect to H.R. 699.

The National Realty Committee supports the concept of H.R. 699 of bifurcating the gain to be recongized on condominium conversion into its two components, capital gain for appreciation during the rental period and ordinary income for the appreciation due to conversion. Such a bill would reduce much of the uncertainty and unfairness that exists under current law pursuant to which either capital treatment or ordinary income treatment applies to all of the gain.

The National Realty Committee believes, however, that the bill contains some drafting problems, such as its failure to address the treatment of nonresidential units permitted by Code Section 167(j)(2)(B) even for a building qualifying as residential rental property under that section. In addition, some thought should be given to expanding the scope of the bill beyond the condominium conversion context to include areas such as cooperative housing conversion and land subdivision.

I

98TH CONGRESS
1ST SESSION

H. R. 1607

To amend the Internal Revenue Code of 1954 to make it clear that certain motor vehicle operating leases are leases.

IN THE HOUSE OF REPRESENTATIVES

FEBRUARY 23, 1983

Mr. GIBBONS introduced the following bill; which was referred to the Committee on Ways and Means

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A BILL

To amend the Internal Revenue Code of 1954 to make it clear that certain motor vehicle operating leases are leases.

Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled, That section 7701 of the Internal Revenue Code of 1954 (relating to definitions) is amended by relettering subsection (d) as (e) and by inserting after subsection (c) the following new subsection:

"(d) MOTOR VEHICLE OPERATING LEASES.—

"(1) IN GENERAL.—For purposes of this title, the fact that a motor vehicle operating agreement contains a terminal rental adjustment clause shall not be taken into account in determining whether such agreement is a lease.

"(2) DEFINITIONS.—For purposes of paragraph (1)—

"(A) The term 'motor vehicle operating agreement' means any agreement with respect to a motor vehicle (including a trailer) under which the lessor—

"(i) is personally liable for the repayment of, or

"(ii) has pledged property (but only to the extent of the net fair market value of the lessor's interest in such property), other than property subject to the agreement or property directly or indirectly financed by indebtedness secured by property subject to the agreement, as security for, all amounts borrowed to finance the acquisition of property subject to the agreement.

"(B) The term 'terminal rental adjustment clause' means a provision of an agreement which permits or requires the rental price to be adjusted upward or downward by reference to the amount realized by the lessor under the agreement upon sale or other disposition of such property."

SEC. 2. The amendment made by the first section of this Act shall apply whether the agreement was entered into before or after the enactment of this Act.

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SUMMARY AND DESCRIPTION

PRESENT LAW

General rules

Cost recovery (ACRS) deductions and investment credits are allowed for property that is used for a business or other income-producing purpose. These tax benefits generally are allowed only to the person who is, in substance, the owner of the property.

If the property is used in a transaction that is considered a lease for Federal income tax purposes, the lessor is treated as the owner entitled to ACRS deductions and investment credits. If the property is used in a transaction that is considered a financing arrangement or conditional sale, the user of the property is considered the owner for tax purposes.

In general, the determination of whether a transaction is a lease or a conditional sale requires a case-by-case analysis of all facts and circumstances. Although the determination of whether a transaction is a lease is inherently factual, a series of general principles has been developed in court cases, revenue rulings, and revenue procedures. Under the general principles, the lessor must show that the property is being used for a business or other income-producing purpose. To establish a business or other income-producing purpose, the lessor must have a reasonable expectation of deriving a profit from the transaction, independent of tax benefits.[1] This requirement precludes lease treatment for a transaction that is intended merely to reduce the user's costs by utilizing the lessor's tax base.

However, the fact that the lessor can show a business or other income-producing purpose does not automatically result in lease treatment, since a profit motive also exists in a financing arrangement. In addition, the lessor has to retain meaningful benefits and burdens of ownership.[2] Thus, lease treatment may be denied if the user of the property has an option to purchase the property at the end of the lease for a price that is nominal in relation to the value of the property at the time of exercise (as determined at the time the parties entered into the transaction), or for a price that is relatively small when compared with the total payments required to be made.[3]

If the residual value to the lessor is nominal, the lessor may be viewed as having transferred full ownership of the property for the rental fee. If the price under a purchase option is more than nominal but low in comparison to fair market value, the lessor may be viewed as having transferred full ownership because of the likelihood that the lessee will exercise the bargain purchase option.[4] Further, if the nominal lessor of property has a contractual right to require the nominal lessee to purchase the property (a "put"), the transaction could be denied lease treatment because a put eliminates the risk borne by owners of property that there will be no market for the property at the end of the lease term.

Terminal rental adjustment clauses

Lease agreements in the motor vehicle industry often contain a terminal rental adjustment clause. A terminal rental adjustment clause permits (or requires) an upward or downward adjustment of rent to make up for any difference between the projected value of a vehicle and the actual value upon lease termination.

Effect of TEFRA provision

The Internal Revenue Service has taken (and continues to take) the position that the presence of a terminal rental adjustment clause in a motor vehicle lease would cause the transaction to be treated as a conditional sale for tax purposes. However, section 210 of the Tax Equity and Fiscal Responsiblity Act of 1982 (TEFRA) prevents the Internal Revenue Service from retroactively denying lease treatment for certain motor vehicle leases, including leases of trailers, by reason of the fact that those leases contain terminal rental adjustment clauses.

Section 210 of TEFRA does not address the legal effect of terminal rental adjustment clauses, nor does it prevent the issuance of regulations addressing the legal effect of these clasuses on a prospective basis. The TEFRA provision applies only to operating leases in which the lessee uses the property for business, as opposed to personal, purposes. A lease is an operating lease if the lessor acquires the property with cash or recourse indebtedness. Thus, the provision does not apply to leveraged leases financed with nonrecourse debt.

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[1] *See Hilton* v. *Comm'r*, 74 T.C. 305 (1980), *aff'd*, 671 F.2d 316 (9th Cir. 1982).

[2] *See Frank Lyon Co.* v. *U.S.*, 435 U.S. 561 (1978), *rev'g*, 536 F.2d 746 (8th Cir. 1976).

[3] *See* Rev. Rul. 55-540, 1955-2 C.B. 39 (and cases cited therein).

[4] *See M&W Gear Co.* v. *Comm'r*, 446 F.2d 841 (7th Cir. 1971).

On November 23, 1982, after the enactment of TEFRA, the Internal Revenue Service issued proposed regulations, which would apply on a prospective basis, that address the legal effect of a terminal rental adjustment clause. Under the proposed regulations, the presence of a terminal rental adjustment clause would indicate that a motor vehicle agreement is not a lease.

Decision in "Swift Dodge"

Prior to the enactment of TEFRA, the U.S. Tax Court addressed the legal effect of terminal rental adjustment clauses in motor vehicle leases in the *Swift Dodge* case.[5] In that case, an automobile dealership, which operated a separate leasing business, acquired most of its cars for lease by borrowing amounts from banks on a recourse basis. The Tax Court held that these nonleveraged tranactions were leases and not conditional sales.

However, after the enactment of TEFRA, the U.S. Court of Appeals for the Ninth Circuit reversed the Tax Court decision, holding that a lease containing a terminal rental adjustment clause was, in substance, a conditional sale to the lessee.[6] The Court of Appeals concluded that, because the lessee bears the risk of loss and risk of fluctuation in value, the only significant risk borne by the lessor is the risk of default by the lessee, a risk assumed by any holder of a security interest in a conditional sale.

EXPLANATION OF THE BILL

The bill would provide that the presence of a terminal rental adjustment clause in a motor vehicle operating agreement is not to be taken into account in determing whether the agreement is a lease.

The bill would apply to operating leases in which the lessee uses the property for business or personal purposes. However, the bill would not apply to leveraged leases financed with nonrecourse debt.

EFFECTIVE DATE

The amendment made by the bill would apply to motor vehicle operating agreements entered into before or after the enactment of the bill

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INTERNATIONAL UNION, UNITED AUTOMOBILE, AEROSPACE & AGRICULTURAL
IMPLEMENT WORKERS OF AMERICA—UAW,
Washington, D.C., November 1, 1983.

Hon. FORTNEY H. (PETE) STARK,
Chairman, Subcommittee on Select Revenue Measures, Committee on Ways and Means, House of Representatives, Longworth House Office Building, Washington, D.C.

DEAR MR. CHAIRMAN: Although the UAW will not be able to testify at the hearing on various tax bills which has been scheduled by the Subcommittee on Select Revenue Measures for November 3, we wish to indicate our support for the legislation which has been introduced by Representative Gibbons (H.R. 1607) to amend the Internal Revenue Code to make it clear that certain motor vehicle operating agreements should be treated as leases for federal income tax purposes. We ask that this communications be included as part of the hearing record.

The proposed legislation would add a definitional provision to the Internal Revenue Code specifying that the presence of a terminal rental adjustment clause shall not be taken into consideration in determining whether a motor vehicle operating agreement constitutes a lease for federal income tax purposes. Enactment of this legislation is needed in order to reverse hasty action by the IRS in publishing a proposed regulation which would deny lease treatment to agreements containing such clauses. This IRS action was taken without any of the tax policy or economic or revenue impact studies contemplated under section 210 of TEFRA.

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[5] *Swift Dodge* v. *Comm'r*, 76 T.C. 547 (1981), *rev'd*, 692 F.2d 651 (9th Cir. 1982).

[6] 692 F.2d 651 (9th Cir. 1982), *rev'g* 76 T.C. 547 (1981). The Ninth Circuit decision was based on general principles (described above) that require a lessor to retain meaningful benefits and burdens of ownership; the decision did not include a discussion of the implications of the enactment of section 210 of TEFRA. Under present law, there is an issue as to whether taxpayers resident in the Ninth Circuit are bound by this decision.

If the IRS action is not reversed, it could have a negative impact on demand for leasing fleets of vehicles. Approximately 4 million vehicles are currently supplied through fleet leases each year, nearly all of which are produced by domestic manufacturers. Studies have estimated that there would be an immediate, one-time decrease of 375,000 in demand for motor vehicles, and an on-going annual decrease of 200,000, if the proposed IRS regulation were allowed to go into effect. This would inevitably lead to further loss of jobs in the automobile and related industries.

The proposed legislation would not have any adverse revenue consequences for the federal government. Indeed, studies have indicated that, unless it is reversed, the IRS action could actually cost the government several hundred million dollars.

For the foregoing reasons, the UAW hopes the House will act speedily to enact H.R. 1607. Your consideration of our views on this issue will be appreciated.

Sincerely,

DICK WARDEN,
Legislative Director.

STATEMENT OF WILLIAM C. TURNBULL, PRESIDENT, NATIONAL AUTOMOBILE DEALERS ASSOCIATION

Mr. Chairman, my statement is presented in support of H.R. 1607 on behalf of the approximately 19,000 franchised new car and truck dealers who are members of the National Automobile Dealers Association of which I am President. I am also a Buick dealer as well as a GMC and International Harvester medium and heavy duty truck dealer from Huntington, West Virginia. In addition, I have a Chevrolet and Oldsmobile dealership in South Carolina. This bill would amend the Internal Revenue Code to make clear that a terminal rental adjustment clause contained in a motor vehicle lease agreement will not be taken into account in determining whether the agreement is a lease or a sale for federal income tax purposes.

Others have submitted detailed statements in support of the bill and I will not duplicate their efforts. The sponsors of the bill and an identical Senate bill (S. 1161) have included excellent discussions in support of the bill at pp. H618 and S5417-S5424 in the Congressional Records for February 23, 1983 and April 27, 1983, respectively, and these deserve careful attention. The purpose of my short statement is to briefly emphasize several points why the bill should be enacted.

The bill would codify an established tax practice. Over three decades, lessors and lessees have consistently treated motor vehicle agreements with terminal rental adjustment clauses as leases for federal income tax purposes. Indeed, until issuance of the technical advice memorandum in late 1979, the Internal Revenue Service never challenged these transactions as other than leases.

Until perhaps recently, the Service has never been whipsawed by these lease transactions. By seeking to challenge the long-established treatment of these transactions, however, the Service now may have been placed in a position of being whipsawed, and this situation will exist so long as the present proposed regulations under § 210 of the Tax Equity and Fiscal Responsibility Act of 1982 ("TEFRA") remain outstanding. By codifying treatment of these transactions as leases, H.R. 1607 would resolve this administrative problem for the Service.

Unless H.R. 1607 is enacted, there will be unnecessary disruption of the motor vehicle leasing industry. Some disruption has already occurred. Some lessors have begun to shy away from these transactions. Leases with terminal rental adjustment clauses are the predominate lease transactions in the motor vehicle leasing industry. They have been shaped in the marketplace and operate to make vehicles available to lessees at the lowest possible rental. As I have stated earlier, the parties to these transactions have always intended these transactions as leases; this has always been the clear intent of the lenders who provide financing to the lessors in these transactions and who look to the leased vehicle as security for their loans. The proposed change in tax treatment sought by the Treasury and the Service in the proposed regulations will substantially increase the industry's operating costs, result in higher rentals charged for leased vehicles, and result in no increased revenue to the Treasury. Certainly this cannot be desirable tax policy.

These lease transactions are not tax-avoidance transactions. As indicated above, they are commercial transactions shaped in the marketplace to accommodate the business needs of lessors and lessess. From the lessor's standpoint, such a lease transaction is entered into to realize an economic profit, not to shelter income from non-leasing activities. Similarly, the lessee is not tax-motivated, but typically enters into these leases to avoid the burdens of ownership, such as, for example, where a large down payment would be required if the transaction, in reality, were a conditional sale. These leases fall in a totally different category from safe-harbor leases, and § 210 of TEFRA specifically recognizes these leases as distinguishable from safe-harbor leases and other tax-motivated lease transactions.

The decision of the U.S. Supreme Court in *Frank Lyon Co.* v. *U.S.*, 435 U.S. 561 (1978), is particularly instructive. In this case, the Supreme Court was faced with the issue whether a transaction involving real estate should be recognized as a lease for tax purposes. In deciding that the transaction should be so recognized, the Court stated that where—

" . . . there is a genuine multiple-party transaction [common in the case of motor vehicle agreements with terminal rent adjustment clauses] with economic substance which is compelled or encouraged by business or regulatory realities, is imbued with tax-independent considerations, and is not shaped solely for tax avoidance features that have meaningless labels attached; the Government should honor the allocation of rights and duties effectuated by the parties . . .". (435 U.S. at 583-4).

I respectfully submit that this principle has an important bearing here. Where the transaction cast by the parties is not tax-motivated and is shaped by business or regulatory realities, the transaction should be honored. H.R. 1607 is totally consistent with this Supreme Court pronouncement.

The last point which should be emphasized is that if these transactions were recast as sales, little or no revenue to the Treasury would be gained thereby. The Treasury revenue estimators, as well as eminent outside economist-consultants to the industry, agree on this point. One such study appears at page S5422 in the Congressional record discussion referred to above.

The needs of this country have been well served for many decades from these extremely useful transactions without tax avoidance. A powerful case therefore exists for the enactment of H.R. 1607 and codification of the established tax treatment of these transactions.

STATEMENT OF GEORGE E. WEIMER, DIRECTOR OF TRANSPORTATION SERVICES, CONTINENTAL TELECOM, INC.

Mr. Chairman, members of the Committee, I am George E. Weimer, Director of Transportation Services, Continental Telecom Inc., and thank you for the opportunity to present this statement in support of H.R. 1607.

I have been actively involved in the motor vehicle leasing industry for over twenty-six years. I began my career with the Hertz Corporation in 1957 and held several positions in that company before leaving in 1973. At the time of my departure from Hertz, I was Vice President of Sales for the Car Leasing Division. I joined Continental Telecom Inc. in 1973 as its Director of Transportation Services and as President of Medusa Leasing Co., a wholly owned leasing subsidiary of Continental Telecom.

Continental Telecom Inc. is headquartered in Atlanta, Georgia. It currently operates telephone companies in thirty-six states and is the third largest independent telephone company in the United States. The overwhelming majority of Continental's two million plus customers reside in rural or isolated regions. Increasing the quality of telephone communication services to these customers is Continental's primary objective. Due to the distances involved in the areas we serve, the efficient use of motor vehicles is essential to expanding and maintaining our commitments to our customers. At the present time, the operating telephone companies which are a part of Continental Telecom utilize over 7,000 vehicles. All of these vehicles are leased under agreements containing TRAC clauses.

I am here today to urge each member of this Subcommittee to work for the enactment of H.R. 1607. Based on my years of experience in the industry, it is my opinion that many of the reasons for Continental Telecom's support of this bill are common to most commercial lessees.

VEHICLE ACQUISITION AND DISPOSAL

The motor vehicle leasing business is primarily a service business. A significant service provided to commercial lessees by lessors is assistance in assessing the lessee's vehicle needs and matching available equipment to meet these needs. This service removes from the lessee the burden of negotiating a favorable price for the acquisition of the vehicle and making arrangements for its delivery. For corporations operating throughout the United States, such services are particularly valuable. At the end of the lease term, the lessor has the responsibility to sell the vehicle at the most favorable price. Finding purchasers for the used vehicles and consummating such sales is becoming increasingly difficult due to rapid changes in the markets for such commodities. Most companies simply aren't equipped to stay abreast of these market changes. It needs to be emphasized that commercial lessees typically don't want to buy the vehicles at the end of the lease term. The vehicle has served its usefulness to us and needs to be replaced.

COMPLIANCE WITH STATE AND LOCAL GOVERNMENT STATUTES AND REGULATIONS

Motor vehicle lessors, as the owners of the vehicles, are responsible for compliance with all state, county and municipal laws relating to the titling and registration of the vehicles leased to companies such as Continental Telecom. It is the responsibility of the motor vehicle lessors to file returns and pay all taxes relating to the leased motor vehicles. Lessors are also the recipients of unpaid parking tickets and similar fines from literally every law enforcement agency in the country! As the members of this Subcommittee can well appreciate, all of these matters must be handled on an expeditious basis or the vehicle may not be permitted to operate in the local jurisdiction. I can assure you that administering this area creates one large headache which the typical lessee is ill-equipped to cure and is grateful to have handled by the lessor.

FINANCING VEHICLE ACQUISITIONS

The use of leasing enables companies to acquire the use of vehicles without becoming involved in the financial arrangements required to purchase the vehicles. The vehicles in commercial fleets typically have service lives which are shorter than the length of investments favored by most commercial lenders. The motor vehicle lessors are totally responsible for the repayment of this debt, with the result that funds available to the lessee company from outside lenders can be utilized by the company in other areas of its business. This is a principal reason for Continental's decision to lease motor vehicles since it has enabled us to enhance the quality of service to our customers which we simply couldn't have accomplished if funds would have had to be utilized to purchase vehicles.

FLEXIBILITY OF TRAC LEASES

TRAC leases provide lessees such as Continental with greater flexibility in the management of their business fleets as compared with the so-called "closed-end" and other forms of lease.

Since closed-end lessors are looking to the resale value of vehicles as a source of profit, as opposed to the periodic rent payments, they often restrict the makes and models of vehicles which they will lease. Closed-end lessors desire to lease only "standard equipped" makes and models which are potentially more readily saleable at more predictable prices than other vehicle types. Such restrictions, which are not imposed by TRAC lessors, would be totally unacceptable to Continental based on the variances in terrain and climatic conditions in which our vehicles operate.

TRAC leases also provide lessees with flexibility as to the duration of our leases in order that the vehicles can be operated as efficiently as possible. Transportation managers need to be able to replace vehicles when it is determined that the maintenance costs of such vehicles are excessive. Notwithstanding recent improvements in vehicle quality control by the domestic manufacturers and their increased emphasis on robotics, occasionally a vehicle comes off the production line which very quickly develops maintenance problems. Maintenance problems often have no relationship to when the vehicle was placed in service, but depend on other factors such as operator use, mileage, road conditions, etc. Decisions on replacements must be made on an individual vehicle-by-vehicle basis when the transportation manager detects that a vehicle may have a potential maintenance problem. Closed-end leases typically contain provisions which impose substantial penalties for removing a vehicle from service prematurely or at other predetermined intervals which preclude such replacement decisions.

Restrictions on a lessee's ability to replace vehicles also thwart efforts by vehicle lessees to increase the fuel efficiency of their fleet. As I'm certain each member of this Subcommittee would agree, increasing a fleet's miles per gallon average not only makes good business sense, but is beneficial to the interests of the nation. I am proud to report that based upon an ability to make timely, unrestricted vehicle replacements last year under our TRAC lease, Continental Telecom expects to reduce the annual fuel consumption of its corporate fleet by more than three million gallons.

TRAC LEASES PROVIDE THE LOWEST NET COST LEASE TRANSACTION

Throughout history lessees have been charged rent for the use of property. TRAC clauses provide a mechanism to enable motor vehicle lessees to achieve this historic economic result in the most efficient way possible. The efficiencies in these transactions result since rentals are determined based on known rather than *estimated* costs. Under a TRAC lease a lessor develops its rental based upon its known costs and desired profit expectation. If the targeted resale value of the vehicle proves to be incorrect, a retroactive rent adjustment is made, based upon the actual resale proceeds from the vehicle. The lessor in a closed-end lease must always include in its determination of rent a resale value less than what it anticipates will be the future resale value of the vehicle. I can assure you, based upon my experience in that area of the industry, that such assumptions are very low to provide a large measure of "insurance" to the lessor. This uncertainty as to resale value equates into higher rentals under closed-end leases and makes it a higher cost form of lease which I feel is unacceptable to most large commercial lessees.

It is also important to recognize that most commercial lessees have adopted periodic, comprehensive vehicle maintenance programs. To our customers, our employee and service vehicle represent Continental Telecom. Our maintenance programs are designed so that our vehicle fleet helps to promote the public image of the company while at the same time providing the safest possible vehicle for use by our employees on the highways in areas which we serve. I can assure you that responsible commercial lessees annually spend large sums of money on vehicle maintenance. The TRAC lease, as opposed to a closed-end or other lease form, is the only device which enables a lessee to be compensated for the increased market value of a vehicle attributable in substantial part to the maintenance dollars spent by the lessee during the vehicle's lease term.

As stated previously, commercial lessees are looking for a lessor to provide needed services. As a practical matter, these services can only be effectively provided when the lessee and lessor are able to work together analyzing new vehicle technology, maintenance programs, vehicle replacement schedules, etc. Inherent in the structure of closed-end leases are provisions which run counter to such an open relationship. Lessees typically try to spend as little as possible on maintenance since such expenditures will only benefit the lessor. The time and money spent in disputes between lessors and lessees under such arrangements concerning vehicle condition at the termination of leases are not productive for either party.

CONCLUSION

H.R. 1607 prevents the IRS from imposing a change in the tax treatment of TRAC leases which would deny to American business the most efficient method of leasing motor vehicles. I know of no benefit to Continental Telecom or any other commercial lessee which would result from allowing the IRS to finalize its proposed regulation. Any alternative to the TRAC lease will result in higher costs to obtain the use of vehicles needed to supply goods and services. Such increased costs to business is not warranted, especially when, as I understand economic experts have concluded, the proposed IRS change would be of no revenue benefit to the government. I urge you to enact H.R. 1607 and to do so as promptly as possible to eliminate the economically unsettling effects of the uncertainty caused by the IRS proposed regulation.

I

98TH CONGRESS
1ST SESSION

H. R. 2476

To provide that no gain shall be recognized for purposes of the Internal Revenue Code of 1954 from any net gift made before March 4, 1981.

IN THE HOUSE OF REPRESENTATIVES

APRIL 12, 1983

Mr. DUNCAN (for himself, Mr. BONER of Tennessee, and Mr. SKELTON) introduced the following bill; which was referred to the Committee on Ways and Means

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A BILL

To provide that no gain shall be recognized for purposes of the Internal Revenue Code of 1954 from any net gift made before March 4, 1981.

Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled, That (a) in the case of any transfer of property subject to gift tax made before March 4, 1981, for purposes of subtitle A of the Internal Revenue Code of 1954, gross income of the donor shall not include any amount attributable to the donee's payment of (or agreement to pay) any gift tax imposed with respect to such gift.

(b) For purposes of subsection (a), the term "gift tax" means—

(1) the tax imposed by chapter 12 of such Code, and

(2) any tax imposed by a State (or the District of Columbia) on transfers by gifts.

(c) If refund or credit of any overpayment of tax resulting from subsection (a) is prevented on the date of the enactment of this Act (or at any time within 1 year after such date) by the operation of any law or rule of law (including res judicata), refund or credit of such overpayment (to the extent attributable to subsection (a)) may nevertheless be made or allowed if claim therefor is filed within 1 year after the date of the enactment of this Act.

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SUMMARY AND DESCRIPTION

PRESENT LAW

The Federal income tax is imposed on income "from whatever source derived" (Code sec. 61). Income may be realized from a variety of indirect means as well as from direct transfers. For example, the benefit resulting from the discharge of one's indebtedness by another party constitutes gross income (sec. 61(a)(12); *Old Colony Tr. Co.* v. *Commissioner*, 279 U.S. 716 (1929); *Crane* v. *Commissioner*, 331 U.S. 1 (1947)).

Present law also imposes a gift tax on certain transfers for less than adequate consideration (sec. 2501). Responsibility for payment of the gift tax is on the donor of the transferred property (sec. 2502), and the gift tax is determined by reference to the value of the property transferred by the donor.

In most cases, the value of the transferred property does not include the amount of gift tax paid by the donor. However, a donor may transfer property pursuant to an agreement with the donee that the donee will pay any gift tax arising from the transfer. In such cases, the amount of the gift is less than the full value of the transferred property, and the donee discharges a debt of the donor with the balance of the transferred value (i.e., a "net gift" is made).

On June 15, 1982, the U.S. Supreme Court ruled in *Diedrich* v. *Commissioner*[1] that payment of gift tax by a donee results in income to the donor to the extent that the gift taxes exceeded the donor's adjusted basis in the transferred property.

EXPLANATION OF THE BILL

The bill would provide that payment of (or agreement to pay) gift tax by a donee with respect to gifts made before March 4, 1981, would not result in income to the donor whose gift tax liability was thereby discharged. (March 4, 1981 was the date on which the U.S. Court of Appeals for the Eighth Circuit held that the donor in the *Diedrich* case was required to recognize income from the disputed transfers.) The provisions of the bill would apply both to Federal gift tax and to any gift tax imposed on such transfers by a State.

EFFECTIVE DATE

The provisions of the bill would be effective on the date of enactment. The period of limitations for filing a claim for refund would be extended or reopened for up to one year after the date of the bill's enactment to permit a claim for refund to be filed in any case in which that period expired before that time.

REVENUE EFFECT

The revenue effect of this bill is not available at this time.

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[1] 457 U.S. 191 (1982).

I

98TH CONGRESS
1ST SESSION

H. R. 2504

To amend the Internal Revenue Code of 1954 to provide that gross income does not include interest on obligations issued by certain educational organizations.

IN THE HOUSE OF REPRESENTATIVES

APRIL 12, 1983

Mr. SCHULZE introduced the following bill; which was referred to the Committee on Ways and Means

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A BILL

To amend the Internal Revenue Code of 1954 to provide that gross income does not include interest on obligations issued by certain educational organizations.

Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled,

SECTION 1. TAX-EXEMPT STATUS OF OBLIGATIONS OF CERTAIN GOVERNMENTAL EDUCATIONAL ORGANIZATIONS.

(a) IN GENERAL.—Subsection (a) of section 103 of the Internal Revenue Code of 1954 (relating to interest on certain governmental obligations) is amended by striking out "and" at the end of paragraph (1), by striking out the period at the end of paragraph (2) and inserting in lieu thereof

"; and", and by adding at the end thereof the following new paragraph:

"(3) the obligations of a qualified educational organization."

(b) QUALIFIED EDUCATIONAL ORGANIZATION DEFINED.—Section 103 of such Code (relating to interest on certain governmental obligations) is amended by redesignating subsection (n) as subsection (o) and inserting after subsection (m) the following new subsection:

"(n) QUALIFIED EDUCATIONAL ORGANIZATION.—For purposes of subsection (a)(3), the term 'qualified educational organization' means an educational organization (within the meaning of section 170(b)(1)(A)(ii)) which—

"(1) grants baccalaureate or higher degrees, and

"(2) is a college or university created by specific act of the legislature of the State within which such college or university is located and for which such legislature has regularly made the appropriations described in section 4 of the Act entitled 'An Act donating Public Lands to the several States and Territories which may provide Colleges for the Benefit of Agriculture and the Mechanic Arts', approved July 2, 1862 (7 U.S.C. 304)."

(c) CONFORMING AMENDMENTS.—

(1)(A) Paragraph (1) of section 103(b) of such Code (relating to industrial development bonds) is amended by striking out "subsection (a)(1) or (2)" and inserting in lieu thereof "subsection (a)(1), (2), or (3)".

(B) The paragraph heading for paragraph (1) of section 103(b) of such Code is amended by striking out "SUBSECTION (a)(1) OR (2)" and inserting in lieu thereof "SUBSECTION (a)(1), (2), OR (3)".

(2)(A) Paragraphs (1) and (2)(A) of section 103(c) of such Code (relating to arbitrage bonds) are each amended by striking out "subsection (a)(1) or (2)" and inserting in lieu thereof "subsection (a)(1), (2), or (3)".

(B) The paragraph heading for paragraph (1) of section 103(c) of such Code is amended by striking out "SUBSECTION (a)(1) OR (2)" and inserting in lieu thereof "SUBSECTION (a)(1), (2), OR (3)".

(3) Paragraph (1) of section 103(l) of such Code (relating to information reporting requirements for certain bonds) is amended by striking out "paragraph (1) or (2)" and inserting in lieu thereof "paragraph (1), (2), or (3)".

(4) Subsection (a) of section 103A of such Code (relating to mortgage subsidy bonds) is amended by striking out "subsection (a)(1) or (2) of section 103"

and inserting in lieu thereof "paragraph (1), (2), or (3) of section 103(a)".

(d) EFFECTIVE DATES.—

(1) IN GENERAL.—The amendments made by this section shall apply to obligations issued after the date of the enactment of this Act.

(2) CERTAIN OBLIGATIONS ISSUED AFTER DECEMBER 31, 1953.—Any obligation of a qualified educational organization (as defined in section 103(n) of the Internal Revenue Code of 1954), as amended by this Act, which was issued after December 31, 1953, and on or before the date of the enactment of this Act shall be treated as an obligation described in section 103(a) of such Code if such organization received, after December 31, 1953, one or more rulings from the Secretary of the Treasury (or his delegate) to the effect that the interest on any such obligation is to be excluded from income under the provisions of section 103(a) of such Code.

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Summary and Description

PRESENT LAW

Federal income tax rules

Tax exemption for State and local obligations.—Interest on State and local government obligations generally is exempt from Federal income tax. Under this rule, State and local governments generally may issue tax-exempt bonds to finance public projects or services, including schools, roads, water, sewer, and general improvement projects and the financing of public debt. Additionally, State and local governments may provide tax-exempt financing for student loans and for use by tax-exempt religious, charitable, scientific, or educational organizations (including tax-exempt colleges and universities).

Treasury regulations provide that State and local obligations include obligations issued by or on behalf of a State or local governmental unit by authorities empowered to issue such obligations. Treas. Reg. Sec. 1.103-1(b). The courts have held that whether an obligation has been issued by or on behalf of a State or local government unit depends on a variety of factors, including the degree of sovereign power exercised by the issuing authority and the relationship of the authority to the State and local government.[1]

Scholarship funding bonds.—In addition to State and local obligations, qualified scholarship funding bonds are exempt from Federal income tax. Qualified scholarship funding bonds are obligations issued by a not-for-profit corporation established and operated exclusively for the purpose of acquiring student loan notes. To qualify for tax exemption, the corporation must be required to use any income (after payment of expenses and debt service) to purchase additional student loan notes, or to pay over any income to the State or a political subdivision.

Federal land-grant colleges

The Morrill Act of 1862[2] distributed Federal land to the States for the purpose of establishing State-supported colleges. Under the terms of the Act, the proceeds of any sale of distributed land are to constitute a perpetual fund, the interest on which is to be regularly appropriated by the State to the endowment and support of at least one college teaching (without excluding other studies) subjects related to the agricultural and mechanical arts.[3] The Federal Government has subsequently made further appropriations to the States for the benefit of the land-grant colleges.

EXPLANATION OF THE BILL

The bill would provide a tax exemption for the interest on obligations of a college or university created by specific act of the State legislature and for which the State has regularly made appropriations of interest from money derived from the sale of land under the Morrill Act of 1862.[4] To benefit from the exemption, the college or university would be required (1) to qualify as an educational organization within the meaning of the charitable contributions provisions of the Internal Revenue Code,[5] and (2) to grant baccalaureate or higher degrees. The bill would not affect the tax-exempt status of any obligations which qualify for exemption under existing law.

It is understood that the intended beneficiary of the bill is the Pennsylvania State University. However, any educational organization that meets the requirements of the bill would qualify to issue tax-exempt obligations.

EFFECTIVE DATE

The bill wold apply generally to obligations issued after the date of enactment. However, the interest on obligations of a qualifying educational organization which were issued after December 31, 1953, would be exempt from tax if the organization received, after December 31, 1953, a Treasury ruling allowing such exemption.

REVENUE EFFECT

It is understood that the bill is intended to benefit only the Pennsylvania State University. If this is the case, the revenue loss is estimated to be less than $10 million per year.

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[1] *Commissioner v. Shamberg's Estate,* 144 F. 2d 998 (2d Cir. 1944), *cert den., 323 U.S. 792 (1945); Philadelphia Nat'l Bank v. U.S. 666 F.2d 834 (3d Cir. 1981) cert. den.,* 102 S. Ct. 2904 (1982).

[2] Laws 1862, c. 132, 37th Cong., 2d Sess., July 3, 1962 (7 U.S.C. sec. 301 *et seq.*)

[3] 7 U.S.C. sec. 304.

[4] 7 U.S.C. sec. 304.

[5] Sec. 170(b)(1)(A)(ii).

98TH CONGRESS
1ST SESSION

H. R. 2568

To amend the Internal Revenue Code of 1954 to repeal the provision which terminates the exclusion for amounts received under certain educational assistance programs.

IN THE HOUSE OF REPRESENTATIVES

APRIL 14, 1983

Mr. SHANNON (for himself, Mr. FRENZEL, Mr. MATSUI, Mr. JENKINS, Mr. WYDEN, Mr. DYMALLY, and Mr. THOMAS of California) introduced the following bill; which was referred to the Committee on Ways and Means

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A BILL

To amend the Internal Revenue Code of 1954 to repeal the provision which terminates the exclusion for amounts received under certain educational assistance programs.

Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled, That subsection (d) of section 127 of the Internal Revenue Code of 1954 (relating to termination) is hereby repealed.

○

SUMMARY AND DESCRIPTION

PRESENT LAW

General rule

Under present law, amounts paid or expenses incurred by an employer for educational assistance provided to an employee are excluded from the employee's gross income if paid or incurred pursuant to a written plan that meets certain requirements and is for the exclusive benefit of the employees (Code sec. 127). The exclusion applies whether or not the education paid for, or furnished by, the employer is related to the employee's job.

Excludable benefits

Under this provision, an employee may exclude from income the value of educational assistance provided by the employer to the employee. Excludable amounts include tuition, fees, and similar expenses, as well as the cost of books, supplies, and equipment paid for, or provided by, the employer. (The exclusion is not available for the cost of tools or supplies provided by the employer if the employee may retain such tools or supplies after completion of the course of instruction.) However, meals, lodging, or transportation may not be excluded under this provision. The exclusion does not apply to educational assistance furnished for courses involving sports, games, or hobbies, unless the education provided involves the business of the employer.

For a program to qualify under this provision, the employee must not be able to choose taxable benefits in lieu of educational assistance benefits. In administering this rule, the business practices of an employer, as well as the written program, are to be taken into account. A qualified educational assistance program need not be funded or approved in advance by the Internal Revenue Service.

The employee may not claim a deduction (e.g., a business expense deduction) or a credit with respect to any amount that is excluded from income under this provision.

Nondiscrimination requirements

For the exclusion to be available, the educational assistance program also must meet certain requirements with respect to nondiscrimination in eligibility.

The program must benefit employees who qualify under a classification set up by the employer and found by the Internal Revenue Service not to be discriminatory in favor of employees who are officers, owners, highly compensated individuals, or their dependents. The program must be available to a broad class of employees, rather than to a particular individual. However, employees may be excluded from a program if they are members of a collective bargaining unit and there is evidence that educational assistance benefits were the subject of good faith bargaining between the unit representatives and the employer or employers offering the program.

A program is not considered discriminatory merely because it is utilized to a greater degree by one class of employees rather than by another class or because successful completion of a course, or attaining a particular course grade, is required for, or considered in, determining reimbursement under the program.

The exclusion does not apply if the share of benefits received by certain employees under the program exceeds a specified level. Specifically, the benefits are not excludable if more than five percent of the benefits are paid to shareholders or owners (or their spouses or dependents, who are employees), each of whom (on any day of the year) owns more than five percent of the stock or of the capital or profits interest in the employer.[1]

Reasonable notification of the availability and terms of the program must be provided to eligible employees.

Treatment of self-employed individuals

An individual who qualifies as an employee within the definition of section 401(c)(1) also is an employee for purposes of these provisions. Thus, in general, the term employee includes self-employed individuals who have earned income for the taxable year, or any prior taxable year, as well as individuals who would have earned income except that their trades or businesses did not have net profits for the taxable year.

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[1] For determining stock ownership in corporations, this provision uses the attribution rules provided under subsections (d) and (e) of section 1563 (without regard to sec. 1563(e)(3)(C)). Ownership interests in unincorporated trades or businesses are to be determined, under regulations, on the basis of similar principles.

An individual who owns the entire interest in an unincorporated trade or business is treated as his or her employer. A partnership is considered the employer of each partner who is also an employee of the partnership.

Payroll tax treatment

Amounts excluded from income as educational assistance are not treated as wages subject to social security (FICA) or unemployment insurance (FUTA) taxes.

Expiration date

The exclusion (Code sec. 127) is to expire for taxable years beginning after December 31, 1983.

EXPLANATION OF THE BILL

The bill would make permanent the section 127 exclusion for certain educational assistance programs.

EFFECTIVE DATE

The bill would be effective on the date of enactment.

ALUMINUM CO. OF AMERICA,
Pittsburgh, Pa., November 10, 1983.

Mr. JOHN J. SALMON,
Chief Counsel, Committee on Ways and Means, House of Representatives, Longworth House Office Building, Washington, D.C.

DEAR MR. SALMON: We appreciate the opportunity to comment on H.R. 2568 on behalf of Aluminum Company of America with respect to educational assistance plans under § 127. This original written statement is being filed with five copies. We strongly support H.R. 2568.

Section 127 was enacted in the Revenue Act of 1978. Pub. L. No. 95-600, § 164; 1978-3 (Vol. 1) C.B. 45. Section 127 generally permits employers to pay for qualified educational assistance to employees without including those amounts in the gross income of the employee. Section 127 will, by its terms, expire at the end of 1983.

If § 127 were permitted to expire at the end of 1983, the value of educational assistance programs furnished by employers to employees after 1983 would generally be included in the income of the employee and subject to Federal income tax withholding and FJCA withholding. Sections 61(a)(1), 3121(a) and 3401(a). Employers would be subject to FICA and FUTA on amounts included in the income of employees which would increase the cost to employers of sponsoring educational assistance programs.

Sections 3121(a) and 3306(b). Thus, the value of the educational assistance programs would be included in the income of the employees, and the employee would not be entitled to any offsetting Federal income tax deduction unless the educational expenditures are for education that "maintains or improves skills" required by the individual's employment or other trade or business, or meets the express requirements of the individual's employer or the requirements of applicable law or regulations imposed as a condition to the retention by the individual of an established employment relationship, status, or rate of compensation. Treas. Reg. § 1.162-5. These types of education are commonly called "job-related education". Even if the employee were entitled to a Federal income tax deduction for "job-related education," he would still be liable for FICA on the educational assistance. However, no deduction is allowed for expenditures for education required of the individual in order to meet the minimum educational requirements for employment qualification in the individual's employment or other trade or business or for expenditures for education which is part of a program of study which will qualify the individual in a new trade or business. Treas. Reg. § 1.262-1(b)(9).

Senate Report No. 95-1263, at 98 provides the Senate's original analysis of the state of the law prior to the enactment of § 127 and the reasons for enacting that section. The reasons stated then for enacting § 127 are as valid today for extending § 127 as they were for originally enacting that legislation. The Senate amendment was adopted by the conference agreement except that the provision was made temporary. House Report No. 95-1800, at 217, 1978-3 (Vol. 1) C.B. 396 and 551. Copies are attached.

Because ambiguities exist in the "maintains or improves skills" test imposed under pre-§ 127 law, taxability of educational assistance programs provided by a particular employer necessarily depended on IRS agents' case-by-case analysis of the skills needed for the jobs held by each employee participating in such programs. The "bright line" test of § 127, which generally excludes from income educational expenses of employees, is preferable to the hazy "maintains or improves skills" test under pre-§ 127 law for the employee, the employer, and the IRS.

The "job-related education" distinction of pre-§ 127 law is often both ambiguous and restrictive and discriminates against the employee with little or no work experience employed in an entry-level position. Such an employee would be required to include in income the value of educational assistance programs and would be required to make out-of-pocket tax payments for employer-provided educational assistance (even though he may be an employee who is least able to pay and even though he receives only services, not an increased paycheck). This may discourage self-improvement. However, the higher the level of job held by an employee, the greater the variety of courses of training which would be likely to qualify as related to that employee's job. Section 127 eliminated the unfairness of this anomalous result.

Allowing § 127 to expire would discriminate against lower-level jobs, particularly those held by minorities and women because pre-§ 127 law restricted these employees to a very narrow range of non-taxable education aid. Pre-§ 127 law is in direct conflict with existing EEO and Affirmative Action guidelines for upgrading job skills and promotion upward mobility of employees.

Section 127 has worked well. It has proven easy to administer for the IRS and is understandable to employers. Best of all, it has resolved the puzzling and punitive features of prior law which discouraged self-improvement by workers.

If America is to regain its leadership role in international commerce, management and technical skills must be continuously enhanced at all levels in the workforce. Making § 127 a permanent part of the Internal Revenue Code is a big step in the right direction.

If you have any questions regarding these comments, please contact L. T. Marchlen, General Tax Attorney for Alcoa, at (412) 553-4621.

Very truly yours,

A. E. GERMAIN,
Vice President, Taxes and Tax Counsel.

Attachments.

(3) to provide reimbursement to volunteers through such organizations for transportation, meals, and other expenses incurred by them in training or providing tax counseling assistance under this section, and such other support and assistance as he determines to be appropriate in carrying out the provisions of this section;

(4) to provide for the use of services, personnel, and facilities of Federal executive agencies and of State and local public agencies with their consent, with or without reimbursement therefor; and

(5) to prescribe such rules and regulations as he deems necessary to carry out the provisions of this section.

(c) Employment of Volunteers.—

(1) In general.—Service as a volunteer in any program carried out under this section shall not be considered service as an employee of the United States. Volunteers under such a program shall not be considered Federal employees and shall not be subject to the provisions of law relating to Federal employment, except that the provisions of section 1905 of title 18, United States Code, shall apply to volunteers as if they were employees of the United States.

(2) Expenses.—Amounts received by volunteers serving in any program carried out under this section as reimbursement for expenses are exempt from taxation under chapters 1 and 21 of the Internal Revenue Code of 1954.

(d) Publicity Relating to Income Tax Provisions Particularly Important to the Elderly.—The Secretary shall, from time to time, undertake to direct the attention of elderly individuals to those provisions of the Internal Revenue Code of 1954 which are particularly important to taxpayers who are elderly individuals, such as the provisions of section 37 (relating to credit for the elderly) and section 121 (relating to one-time exclusion of gain from sale of principal residence) of the Internal Revenue Code of 1954.

(e) Definitions.—For purposes of this section—

(1) The term "Secretary" means the Secretary of the Treasury or his delegate.

(2) The term "elderly individual" means an individual who has attained the age of 60 years as of the close of his taxable year.

(3) The term "Federal income tax return" means any return required under chapter 61 of the Internal Revenue Code of 1954 with respect to the tax imposed on an individual under chapter 1 of such Code.

(f) Authorization of Appropriations.—There are authorized to be appropriated for the purpose of carrying out the provisions of this section $2,500,000 for the fiscal year ending September 30, 1979, and $3,500,000 for the fiscal year ending September 30, 1980.

SEC. 164. EXCLUSION OF VALUE OF CERTAIN EDUCATIONAL ASSISTANCE PROGRAMS.

(a) In General.—Part III of subchapter B of chapter 1 (relating to items specifically excluded from gross income) is amended by redesignating section 127 as 128 and by inserting after section 126 the following new section:

"SEC. 127. EDUCATIONAL ASSISTANCE PROGRAMS.

"(a) General Rule.—Gross income of an employee does not include amounts paid or expenses incurred by the employer for educational assistance to the employee if the assistance is furnished pursuant to a program which is described in subsection (b).

"(b) Educational Assistance Program.—

"(1) In general.—For purposes of this section an educational assistance program is a separate written plan of an employer for the exclusive benefit of his employees to provide such employees with educational assistance. The program must meet the requirements of paragraphs (2) through (6) of this subsection.

"(2) Eligibility.—The program shall benefit employees who qualify under a classification set up by the employer and found by the Secretary not to be discriminatory in favor of employees who are officers, owners, or highly compensated, or their dependents. For purposes of this paragraph, there shall be excluded from consideration employees not included in the program who are included in a unit of employees covered by an agreement which the Secretary of Labor finds to be a collective bargaining agreement between employee representatives and one or more employers, if there is evidence that educational assistance benefits were the subject of good faith bargaining between such employee representatives and such employer or employers.

"(3) Principal shareholders or owners.—Not more than 5 percent of the amounts paid or incurred by the employer for educational assistance during the year may be provided for the class of individuals who are shareholders or owners (or their spouses or dependents), each of whom (on any day of the year) owns more than 5 percent of the stock or of the capital or profits interest in the employer.

"(4) Other benefits as an alternative.—A program must not provide eligible employees with a choice between educational assistance and other remuneration includible in gross income. For purposes of this section, the business practices of the employer (as well as the written program) will be taken into account.

"(5) No funding required.—A program referred to in paragraph (1) is not required to be funded.

"(6) Notification of employees.—Reasonable notification of the availability and terms of the program must be provided to eligible employees.

"(c) Definitions; Special Rules.—For purposes of this section—

"(1) Educational assistance.—The term 'educational assistance' means—

"(A) the payment, by an employer, of expenses incurred by or on behalf of an employee for education of the employee (including, but not limited to, tuition, fees, and similar payments, books, supplies, and equipment), and

"(B) the provision, by an employer, of courses of instruction for such employee (including books, supplies, and equipment),

but does not include payment for, or the provision of, tools or supplies which may be retained by the employee after completion of a course of instruction, or meals, lodging, or transportation. The term 'educational assistance' also does not include any payment for, or the provision of any benefits with respect to, any course or other education involving sports, games, or hobbies.

"(2) Employee.—The term 'employee' includes, for any year, an individual who is an employee within the meaning of section 401(c)(1)(relating to self-employed individuals).

"(3) Employer.—An individual who owns the entire interest in an unincorporated trade or business shall be treated as his own employer. A partnership shall be treated as the employer of each partner who is an employee within the meaning of paragraph (2).

"(4) Attribution rules.—

"(A) Ownership of stock.—Ownership of stock in a corporation shall be determined in accordance with the rules provided under subsections (d) and (e) of section 1563 (without regard to section 1563(e)(3)(C)).

"(B) Interest in unincorporated trade or business.—The interest of an employee in a trade or business which is not incorporated shall be determined in accordance with regulations prescribed by the Secretary, which shall be based on principles similar to the principles which apply in the case of subparagraph (A).

"(5) Certain tests not applicable.—An educational assistance program shall not be held or considered to fail to meet any requirements of subsection (b) merely because—

"(A) of utilization rates for the different types of educational assistance made available under the program; or

"(B) successful completion, or attaining a particular course grade, is required for or considered in determining reimbursement under the program.

"(6) Relationship to current law.—This section shall not be construed to affect the deduction or inclusion in income of amounts (not within the exclusion under this section) which are paid or incurred, or received as reimbursement, for educational expenses under section 117, 162 or 212.

"(7) Disallowance of excluded amounts as credit or deduction.—No deduction or credit shall be allowed under any other section of this chapter for any amount excluded from income by reason of this section.

"(d) Termination.—This section shall not apply to taxable years beginning after December 31, 1983."

(b) Treatment of Employer Educational Assistance Benefits for Purposes of Withholding, Unemployment Taxes, and Social Security Taxes.—

(1) Section 3401(a) (relating to the definition of wages for purposes of collection of income tax at the source) is amended—

(A) by striking out "or" at the end of paragraph (16);

(B) by striking out the period at the end of paragraph (17); and

(C) by adding at the end thereof the following new paragraph:

"(18) for any payment made, or benefit furnished, to or for the benefit of an employee if at the time of such payment or such furnishing it is reasonable to believe that the employee will be able to exclude such payment or benefit from income under section 124.".

(2) Section 3306(b) (relating to the definition of wages for purposes of the Federal Unemployment Tax Act) is amended—

(A) by striking out "or" at the end of paragraph (11);

(B) by striking out the period at the end of paragraph (12) and inserting in lieu thereof "; or"; and

(C) by adding at the end thereof the following new paragraph:

"(13) any payment made, or benefit furnished, to or for the benefit of an employee if at the time of such payment or such furnishing it is reasonable to believe that the employee will be able to exclude such payment or benefit from income under section 127.".

(3) Section 3121(a) (relating to the definition of wages for purposes of the Federal Insurance Contributions Act) is amended—

(A) by striking out "or" at the end of paragraph (16);

(B) by striking out the period at the end of subparagraph (17) and inserting in lieu thereof "; or"; and

(C) by adding at the end thereof the following new paragraph:

"(18) any payment made, or benefit furnished, to or for the benefit of an employee if at the time of such payment or such furnishing it is reasonable to believe that the employee will be able to exclude such payment or benefit from income under section 127.".

(4) Section 209 of the Social Security Act is amended—

(A) by striking out "or" at the end of subsection (o);

(B) by striking out the period at the end of subsection (p) and inserting in lieu thereof "; or"; and

(C) by inserting after subsection (p) and before the sentence beginning with "For purposes of this title, in the case of domestic service" the following new subsection:

"(q) Any payment made, or benefit furnished, to or for the benefit of an employee if at the time of such payment or such furnishing it is reasonable to believe that the employee will be able to exclude such payment or benefit from income under section 127 of the Internal Revenue Code of 1954."

(c) CLERICAL AMENDMENT.—The table of sections for such part is amended by striking out the item relating to section 124 and inserting in lieu thereof the following:

"Sec. 124. Educational assistance programs.
"Sec. 125. Cross references to other Acts.".

(d) EFFECTIVE DATE.—The amendments made by this section shall apply with respect to taxable years beginning after December 31, 1978.

TITLE II—TAX SHELTER PROVISIONS

Subtitle A—Provisions Related To At Risk Rules

SEC. 201. EXTENSION OF SECTION 465 AT RISK RULES TO ALL ACTIVITIES OTHER THAN REAL ESTATE.

(a) EXTENSION.—Subsection (c) of section 465 (relating to activities to which section applies) is amended by adding at the end thereof the following new paragraph:

"(3) EXTENSION TO OTHER ACTIVITIES.—

"(A) IN GENERAL.—In the case of taxable years beginning after December 31, 1978, this section also applies to each activity—

"(i) engaged in by the taxpayer in carrying on a trade or business or for the production of income, and

"(ii) which is not described in paragraph (1).

"(B) AGGREGATION OF ACTIVITIES WHERE TAXPAYER ACTIVELY PARTICIPATES IN MANAGEMENT OF TRADE OR BUSI-

Section 2117 of the Tax Reform Act of 1976 (P.L. 94–455) provided that in the case of loans forgiven prior to January 1, 1979, no amount was to be included in gross income by reason of the discharge of all or part of the indebtedness of the individual under certain student loan programs. The exclusion applies to a discharge of indebtedness if the discharge was pursuant to a provision of the loan agreement under which all or part of the indebtedness would be discharged if the individual works for a certain period of time in certain professions in certain geographical areas or for certain classes of employers. The amendment made by the 1976 Act applies to student loans made to an individual to assist him in attending an educational institution only if the loan was made by the United States or an instrumentality or agency thereof or by a State or local government either directly or pursuant to an agreement with an educational institution.

Reasons for change

Many States and cities have experienced difficulty in attracting doctors, nurses, and teachers to serve certain areas, including both rural communities and low-income urban areas. A provision in student loan programs for loan cancellation in certain circumstances is intended to encourage the recipients, upon graduation, to perform needed services in such areas. The committee agrees with the proponents of these programs that the loan cancellation is not primarily for the benefit of the grantor, as the Service ruled in 1973, but for the benefit of the entire community. The committee believes that the exclusion from income of the amount of indebtedness discharged in exchange for these services would promote the purpose of the programs.

Explanation of provision

The provision extends to loans forgiven prior to January 1, 1983, the exclusion from income provided by the Tax Reform Act of 1976 with respect to cancellation of certain student loans. Accordingly, no amount shall be included in gross income by reason of the discharge of all or part of a student loan of the type described in section 2117 of the 1976 Act if the loan is forgiven prior to January 1, 1983.

There is no comparable provision in the House bill.

Effective date

The amendment applies with respect to loans forgiven prior to January 1, 1983.

Revenue effect

This provision will result in reduction of budget receipts of less than $5 million annually.

3. Employer educational assistance programs (sec. 163 of the bill and new sec. 124 of the Code)

Present law

Under present law, there is no provision for a specific exclusion from an individual's income for educational assistance provided by an employer. Thus, a determination as to whether an individual is required to include in income money or benefits furnished to assist him in his education generally is governed by sections 61 and 117 of the Code.

Section 61 provides that unless otherwise excluded by law gross income means all income from whatever source derived including, but not limited to, compensation for services. Under section 117, subject to certain qualifications, amounts received as scholarships at educational institutions and amounts received as fellowship grants are excluded from gross income.[1] The exclusion also covers incidental amounts received to cover expenses for travel, research, clerical help, and equipment when they are expended for these purposes.

The exclusion for scholarships and fellowship grants is restricted to educational grants by relatively disinterested grantors who do not require any significant consideration from the recipient.[2]

Under present law (Reg. § 1.162–5), educational expenditures made by an individual for his own education generally are deductible if they are for education that (1) maintains or improves skills required by the individual's employment or other trade or business, or (2) meets the express requirements of the individual's employer or the requirements of applicable law or regulations imposed as a condition to the retention by the individual of an established employment relationship, status, or rate of compensation. These types of education are commonly called "job-related education." However, no deduction is allowed for expenditures for education required of the individual in order to meet the minimum educational requirements for employment qualification in the individual's employment or other trade or business or for expenditures for education which is part of a program of study which will qualify the individual in a new trade or business. Such expenses may not be deducted even if the education maintains or improves skills required by the individual in the individual's employment or other trade or business or meets the express requirements of the individual's employer or applicable law or regulations. Nondeductible educational expenditures are personal expenses of the employee. Similarly, expenses which are incurred by an individual for recreation and which are not connected with a trade or business or the production of income, such as taking courses in connection with a hobby, are personal expenses of the individual and are not deductible. Thus, unless the educational expenses are deductible to the individual under the above rules, an employee ordinarily will have income which is not offset by deductions in the following situations:

(1) the employee is reimbursed for educational expenses by the employer;

(2) the employee's educational expenses are paid directly by the employer; or

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[1] To some extent, qualifications differ for individuals who are candidates for degrees and individuals who are not degree candidates. A degree candidate cannot exclude any amount to the extent it represents compensation for teaching, research, or other part-time services which the individual is required to render in order to obtain the grant unless such services are required of all candidates for a particular degree as a condition for receiving the degree.

In the case of a non-degree candidate, the exclusion is available only for up to $300 per month for no more than 36 months and then only if the grantor of the scholarship is a qualified governmental unit, charity, or international organization.

[2] *Bingler v. Johnson*, 394 U.S. 741 (1969).

(3) the employer furnishes educational services directly to the employee.

An employer ordinarily can deduct amounts paid or incurred to provide educational assistance to employees because such amounts are treated as compensation under section 61.[3] However, such amounts may be nondeductible in some cases, for example, either as excessive compensation or as dividends, if the benefitted employees are shareholders.

Generally, unless specifically excluded by statute, all remuneration paid to employees, regardless of the form in which paid, constitutes wages subject to withholding of income and employment taxes. Remuneration is not necessarily excluded from the definition of employment tax wages for purposes of employment taxes and income tax withholding simply because it is excludible from gross income under some other section of the Code. However, Treasury regulations provide that certain advances and reimbursements paid to employees for ordinary and necessary business expenses are excluded from the definition of wages for withholding and employment tax purposes. Pursuant to these regulations, the Internal Revenue Service has ruled that educational expenses paid on behalf of, or reimbursed to, an employee for courses which maintain or improve skills required in employment, or meet express requirements of an employer as a condition to retaining employment, that is, job-related educational expenses, are excludable from the wages of the employee for purposes of employment taxes and income tax withholding. If the courses do not satisfy these tests, their cost is considered a personal expense of the employee and the advance or reimbursement is includible in wages and subject to employment taxes and withholding.[4]

Reasons for change

The committee believes that the treatment of employer-provided educational assistance under present law occasionally gives rise to inequitable administration, adds to the complexity of the tax system, and can act as a disincentive to continuing education, particularly among those at the lower end of the economic scale.

Because ambiguities exist in the "improve or maintain skills" test imposed under present law, the taxability of educational assistance programs of particular employers necessarily depends on IRS agents' case-by-case analyses of the skills needed for the jobs held by each employee participating in such programs.

The "job-related" distinction is often both ambiguous and restrictive. For example, if a person with little or no work experience is employed in an entry-level position and receives training from his employer to advance to a job requiring some greater skills or experience, the value of the training may be taxable. This may discourage self-improvement. If a typist, for example, receives training to be a secretary, or if a secretary receives training in a paralegal program, it might be considered not job-related. Also, if a clerical employee receives computer training, it may be treated as not job-related, even though the employee's job may require computer skills in the future because of normal advances in business technology.

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[3] In situations where an employer acquires items with a useful life in excess of one year and uses them for the direct furnishing of educational assistance to employees, the cost would have to be recovered through deductions for depreciation over the useful lives of such items. In other situations, the deductions would normally be allowed when the amount is paid or incurred (depending on the employer's method of accounting).

[4] See Treas. Reg. §§ 31.3121(a)–1(h), 31.3306(b)–1(h), and 31.3401(a)–1(b)(2); Rev. Ruls. 78–184, 1978–20 I.R.B. 19; 76–62, 1976–1 C.B. 12; 76–71, 1976–1 C.B. 308; and 76–352, 1976–2 C.B. 87.

However, the higher the level of job held by an employee, the greater the variety courses or training likely to qualify as related to the employee's job. The committee believes that the unfairness of this anomalous result should be eliminated.

The committee also intends to reduce to the complexity of present law in this area. Not only must the Internal Revenue Service use valuable personnel time in making determinations of taxability, but employees and employers also must justify their positions. The employer also must determine whether income tax withholding and employment taxes apply to reimbursement.

More serious even than the potential inequities of administration and the complexities of the tax law is the disincentive to upward mobility. Although most citizens recognize the need to provide greater access to educational and economic opportunity to those who have had limited access in the past, the tax law presently requires out-of-pocket tax payments for employer-provided educational assistance from those least able to pay, even though they receive only services, not an increased paycheck.

Therefore, the committee provides an exclusion for employer-provided educational assistance. To avoid abuse of this expanded tax-free treatment of educational assistance, the bill limits the exclusion to benefits provided to employees and provides antidiscrimination rules.

Explanation of provision

General

The provision excludes from an employee's gross income amounts paid for expenses incurred by the employer for educational assistance to the employee if such amounts are paid or such expenses are incurred pursuant to a program which meets certain requirements. In the case of education paid for, or furnished by, an individual's employer under such a program, the provision eliminates the need to distinguish job-related educational expenses from personal educational expenses for income tax purposes.[4]

Excludible benefits

The educational benefits which may be excluded from income are those furnished by an employer only to employees. The types of educational assistance which may be furnished are not restricted. The employer may provide educational assistance to the employee directly or the employer may reimburse the employee for the latter's expenses. Under the bill, an employee can exclude from income tuition, fees, and similar payments, as well as the cost of books, supplies, and equipment paid for, or provided by, his employer; however, the employee cannot exclude tools or supplies which the employer provides and which the employee may retain after completion of the course of instruction. Meals, lodging, or transportation also may not be excluded under this section. There is no restriction as to who may furnish the educational assistance. Such assistance may be furnished by an educational institution or any other party. Also, the employer, alone or in conjunction with other employers, may furnish the education directly to the employees. The education which may be furnished is not limited to job-related courses nor to courses which are part of a degree program. However, the exclusion does not apply to educational assistance furnished for courses involving sports, games, or hobbies, except where the education provided involves the business of the employer.

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[4] However, such a distinction still would have to be made in situations where the education is not excluded under this provision.

For a program to qualify under this provision, the employees must not be able to choose taxable benefits in lieu of the educational benefits.

A taxpayer may not claim any deducation, for example, a business expense deduction, nor may he claim any credit with respect to any amount which is excluded from his income under this provision. Thus, no double tax benefit can be obtained.

An employer educational assistance program is not required to be funded nor to be approved in advance by the Internal Revenue Service.

Nondiscrimination requirements

In order to be a qualified program, an educational assistance program also must meet requirements with respect to nondiscrimination in contributions or benefits and in eligibility for enrollment. The bill requires that a program must benefit employees who qualify under a classification set up by the employer and found by the Secretary not to be discriminatory in favor of employees who are officers, shareholders, self-employed individuals, highly compensated, or their dependents. The program must be available to a broad class of employees rather than to a particular individual. However, employees may be excluded from a program if they are members of a collective bargaining unit and there is evidence that educational assistance benefits were the subject of good faith bargaining between the unit and the employer or employers offering the program.

The bill specifically provides that a program shall not be considered discriminatory merely because it is utilized to a greater degree by one class of employees than by another class or because successful completion of a course, or attaining a particular course grade, is required for, or considered in, determining the availability of benefits.

Reasonable notification of the availability and terms of the program must be provided to eligible employees.

Operation

Under the bill, the exclusion does not apply if the program discriminates in favor of certain employees. A program is discriminatory if more than 5 percent of the benefits can be paid to shareholders, officers, highly compensated employees, self-employed individuals, or dependents of any of these groups.

Special rules

An individual who qualifies as an employee within the definition in section 401(c)(1) of the Code is also an employee for purposes of these provisions. Thus, in general, the term "self-employed individual" means, and the term "employee" includes, individuals who have earned income for a taxable year, as well as individuals who would have earned income except that their trades or businesses did not have net profits for a taxable year.

An individual who owns the entire interest in an unincorporated trade or business is treated as his own employer. A partnership is considered the employer of each partner who is also an employee of the partnership.

For determining stock ownership in corporations, the bill adopts the attribution rules provided under subsections (d) and (e) of section 1563 (without regard to sec. 1563(e)(3)(C)). The Treasury Department is to issue regulations for determining ownership interests in unincorporated trades or businesses, such as partnerships or proprietorships, following the principles governing the attribution of stock ownership.

The bill also provides that amounts excluded from income as educational assistance are not to be treated as wages subject to withholding of income nor as wages subject to employment taxes.

There is no comparable provision in the House bill.

Effective date

The bill applies to taxable years beginning after December 31, 1978.

Revenue effect

It is estimated that this provision will reduce calendar year liabilities by $23 million in 1979, $29 million in 1980, and $40 million in 1983. Budget receipts will be reduced by $18 million in fiscal year 1979, $28 million in fiscal year 1980, and $39 million in fiscal year 1983.

4. Tax counseling for the elderly (Sec. 164 of the bill)

Present law

Present law provides a number of specific tax benefits for elderly or retired individuals; however, it contains no provision dealing with tax counseling for the elderly. The Internal Revenue Service has, however, established a Volunteer Income Tax Assistance (VITA) program which provides individual taxpayer assistance through the use of Internal Revenue Service-trained volunteers.

Reasons for change

Preparation of a tax return is frequently a difficult task for the elderly. Upon reaching retirement age, taxpayers are often confronted with new provisions and complex forms. They often must complete a tax credit for the elderly schedule or a retirement income credit schedule, determine the taxable portion of retirement annuities, or compute the taxable gain when they sell their residences. For an untrained elderly individual, who has perhaps had no experience with the preparation of tax returns other than the short form 1040A, this change in circumstances may result in overpayment of tax. Alterna-

28. Employer educational assistance programs

House bill.—No provision.

Senate amendment.—Under present law, employer-provided educational assistance is includible in an employee's income and is subject to tax unless the education is "job-related." Educational expenditures generally are deductible if they are for education that (1) maintains or improves skill required by the individual's employment or other trade or business, or (2) meets the express requirements of the individual's employer or the requirements of applicable law or regulations imposed as a condition to the retention of an established employment relationship, status or rate of compensation.

The Senate amendment excludes from an employee's income educational assistance provided by an employer under a qualified program. Excludible "educational assistance" includes tuition, fees, books, course supplies and similar items, but does not include personal living expenses nor any benefits for instruction involving sports, games, or hobbies.

A qualified program must be—

(1) a separate written plan of an employer;

(2) for the exclusive benefit of his employees; and

(3) nondiscriminatory with respect to eligibility and participation.

No more than 5 percent of an employer's annual costs for a program may benefit officers, highly compensated individuals, or owners of more than 5 percent of the employer's stock capital, or profits interests. Employees may not elect taxable compensation in lieu of educational assistance. No deduction or credit can be claimed with respect to any amount excluded under this provision.

Excludible assistance also is exempt from employment taxes.

This provision applies to taxable years beginning after December 31, 1978.

Conference agreement.—The conference agreement follows the Senate amendment except that the provision is temporary. The exclusion applies to taxable years beginning after December 31, 1978, and ending before January 1, 1984.

29. Tax counseling for the elderly

House bill.—No provision.

Senate amendment.—Present law contains no provision specifically authorizing tax counseling for the elderly. However, the Internal Revenue Service has established a Volunteer Income Tax Assistance Program, which is designed specifically to provide assistance to low-income taxpayers and others.

The Senate amendment authorizes the Secretary of the Treasury, through the Internal Revenue Service, to enter into training and technical assistance agreements with private or public non-profit agencies and organizations to prepare volunteers to provide tax counseling assistance for elderly individuals in the preparation of their Federal income tax returns. Under the amendment, an "elderly individual" is defined as a person who has attained the age of 60.

The amendment authorizes the Service to provide reimbursement to volunteers for transportation, meals, and other expenses incurred

STATEMENT OF THE AMERICAN SOCIETY FOR TRAINING AND DEVELOPMENT

The American Society for Training and Development is especially pleased to comment on H.R. 2568, introduced by Rep. Jim Shannon. Our Society represents those professionals in the world of work who are responsible for employer sponsored employee training and education programs. We have nearly 50,000 member in our national organization and in the 139 chapters throughout the United States. Our members are engaged in retraining the nation's work force from entry level youth to top management.

The employee educational assistance provisions of H.R. 2568 allow a permanent extension of Section 127 of the IRS code (Revenue Act of 1978) which eliminates taxing of employees for improving their job competence.

The employer-provided educational assistance provisions eliminated the problems of the previous IRS regulations which were causing administrative confusion, leading to increasing tax court litigation for employers. By broadening the employee income tax exclusion for employer educational assistance, those problems have been eliminated, and more employees have taken advantage of their employer's educational aid. In 1978, we submitted survey data which showed that employee participation was three times greater when the employer's practice was not to withhold income tax for educational aid. Thus, greater proportions of the work force, and especially those at lower levels, are now participting in employer-provided educational assistance.

Now, with all the international economic competition, it is imperative that we build the highest quality human capital and work force productivity.

There is little question that a competent, well-trained work force is central to the economic vitality of our business and industrial enterprise. Employers are now faced not only with large numbers of employees who have less than adequate basic educationa, but they are also faced with rapidly changing needs for new job knowledge and skills. The quickening pace of change in technology, the economy, work force demographics, and labor/management contract agreements are creating even more intensive demands for work force education and training.

Employer-provided educational assistance is an important and effective means to help upgrade skills of American workers.

As attestation regarding the practicality of these provisions, we have not heard a single instance of abuse or any other problem with the 1978 provisions to date.

The alternative of not extending these provisions and reverting to the former IRS regulations, which excluded employer educational assistance that was related directly to the employee's present position only, would be severely regressive, and a disincentive to building the quality of the nation's work force.

As we pointed out in 1978, the measure has the added benefit of simplifying the administration of the tax code and should, in the long run, increase the earning power of participating employees, and therefore produce more tax revenue from those increased earnings.

We would especially like to point out that if H.R. 2568 is not enacted, those workers who would be retrained under the new labor agreements in the auto industry and in the telecommunications industries would have to pay income tax on the value of the retraining they receive. In addition to serving as a deterrent to retraining for the individual displaced worker, it could also be seen as a negative signal from the Congress for this positive, new kind of labor-management cooperation.

We believe that this is the kind of legislation that might be termed "win-win"—everyone benefits—the employees, the employers, and the nation's economy. We urge Congress to pass a permanent extension of employer-provided educational assistance provisions before they expire in December.

MAYER BROWN & PLATT,
COUNSELORS AT LAW,
Washington, D.C., November 11, 1983.

Hon. FORTNEY H. STARK,
Chairman, Subcommittee on Select Revenue Measures, Committee on Ways and Means, Longworth House Office Building, Washington, D.C.

DEAR MR. CHAIRMAN: The ERISA Industry Committee (ERIC) strongly support enactment of H.R. 2568, as originally introduced, to make section 127 permanent. We request that this statement be made part of the record of your November 3 hearing.

We understand that on November 8 the Subcommittee approved H.R. 2568, with modifications, for full Committee action. While ERIC would prefer that section 127 be made permanent, it also supports the Subcommittee's recommended two-year extension. However, the proposed reporting requirements would be burdensome and difficult to administer. Accordingly, they should be deleted when the bill is considered by the full Committee.

As you may know, ERIC is an organization of more than one hundred major employers which maintain employee benefit plans. ERIC members include half of the nation's fifty largest industrial companies and represent a broad cross-section of the nation's largest retailers, utilities, banks, and insurers. These companies typically sponsor qualified educational assistance programs for their employees. These programs have been successful and should be continued.

BACKGROUND

Under section 127, an employee may exclude from his gross income tuition fees, and the costs of educational books, supplies, and equipment paid for or supplied by his employer. Section 127 was enacted in 1978 in order to eliminate "the need to distinguish job-related educational expenses from personal educational expenses for income tax purposes". S. Rep. No. 95-1263, 95th Cong., 2d Sess. 101 (1978).[1] The education need not be job-related, but it cannot include "hobby" or recreational instruction. An employer's program must be available on a nondiscriminatory basis and must be nondiscriminatory in operation. Thus, the programs do not favor the highly compensated, offices or owners. By its terms, section 127 expires for virtually all employees at the end of this year.

BENEFITS FOR LOWER PAID AND MINORITIES

The experience of ERIC companies is that educational assistance programs have provided the most significant benefits to entry-level, lower paid, and poorly educated employees, including significant numbers of women and minorities. Many of these employees use these programs to pursue high school equivalency or associate or baccalaureate degrees which qualify them for new or more remunerative positions. Most would have found it difficult, if not impossible, to advance their education without employer assistance.

Significant numbers of employees participate in these programs to pursue education in math, accounting, and computer science. The significant shift in employment opportunities from unskilled or semi-skilled heavy manufacturing to high technology and service industries has created a compelling need for employee education and training in these fields.

Without employer-provided assistance, many feel that those who have taken advantage of these programs would not be able to compete for the higher technology and management positions which afford the greatest employment opportunities and that employers would have significant difficulty obtaining trained and qualified employees. Thus, employer educational assistance programs increase the skilled work force. They benefit individuals taking courses, their employer who provide assistance, and the nation's economy.

The staff has estimated that the revenue loss from making section 127 permanent would range from $25 million for 1984 to $54 million for 1988. These estimates do not take into account the "feedback" revenue which would result from the higher taxes paid by employees who obtain more remunerative employment as a result of participating in these programs. More important, the estimates of lost revenue are relatively small amounts and cannot take into account fully the other benefits to individuals, society, and the nation's economy which cannot be readily quantified.

The Treasury opposed H.R. 2568 in part because "taxpayers with the highest incomes will receive the greatest benefit from the income exclusion". This, however, is a function of progressive tax rates and is not a true measure of the value of the benefit to the individual. The true value of the exclusion may well be greatest for the lower paid because they would not have other funds available to pursue their education.

THE PRIOR JOB-RELATED TEST IS AMBIGUOUS, UNFAIR, AND UNSATISFACTORY

Permitting section 127 to expire at the end of 1983 would be detrimental to employees, employers, and the Service. Employers and employees would have to determine whether education and training was job-related. Those who could establish that it was job-related would either exclude the value of their training provided directly by the employer from their incomes or would include employer-provided assistance in their incomes but would deduct corresponding amounts under section 162. Those who could not establish job-relatedness would have to include the value of the employer-provided assistance in their incomes, would have no deductions, and would be taxable on such assistance.

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[1] Section 127 originated in the Senate amendment to the House bill. There was no corresponding provision in the House bill.

For example, a highly educated, skilled employee, such as an accountant, computer manager, or staff attorney, who took courses in his field to remain current, would be able to offset the employer-provided assistance included in income by deducting his educational expenses. However, a less educated person taking similar courses to qualify for a new position would be required to include the employer-provided assistance in income and would be allowed no deduction. Thus, the job-related standard discriminates against those who need the training most. If section 127 were allowed to expire, those in higher paying positions would be least affected, and it is feared that many, if not most, entry-level, lower paid employees would no longer take advantage of their employers' programs.

As suggested by the enclosed excerpt from the 1978 Finance Committee Report on section 127, the application of the job-related standard for excludability or deductibility of employer-provided educational assistance was inequitable, was fraught with controversy, and engendered frequent audits. Enforcing such a rule would again be burdensome to the Service, to employers who would attempt to determine whether a proposed course of study satisfied the job-related test, and to employees who would have to make difficult decisions regarding their tax liabilities and who would be subject to challenge on audit. This would discourage offering these programs and participation in them.

THE PROPOSED REPORTING REQUIREMENT IS ILL-ADVISED AND SHOULD BE DELETED

Your November 9 press release indicates that the Subcommittee has approved an amendment to H.R. 2568 which would require employers to make annual reports on educational assistance plans. Although no bill language or other details have been released, we understand that these reports might require employers to specify the total amount of educational assistance provided to all employees and the value of the assistance provided each employee. Preparing such reports could be very burdensome, particularly for those employers who have many thousands of employees participating in several different types of educational assistance programs. If information is required with respect to each such employee, the required report could be quite voluminous.

In addition, requiring reports for all amounts excludable under section 127 would again raise the very job-relatedness question which section 127 was enacted to eliminate. In determining whether to report the amount of educational or training assistance provided to employees, very difficult and sophisticated judgments would have to be made on a case by case basis to determine whether such amounts would have constituted taxable income to the employee but for section 127. As indicated above, these determinations are difficult and controversial. They could not be made by clerical personnel routinely filing reports.

Similarly, determining the value to be reported would be difficult in the case of assistance provided directly by the employer. There is no problem reporting an amount paid to an educational institution for an employee's tuition, but, when the training is provided by the employer, difficult questions of valuation and attribution of employee salaries, use of facilities, overhead, and so forth would be raised. Again, these types of determinations could not be made by clerical personnel.

Accordingly, the reporting requirement should be deleted. I would welcome the opportunity to pursue this matter with your or your staff.

Respectfully,

JERRY L. OPPENHEIMER.

Enclosure.

SENATE REPORT NO. 95-1263, 95TH CONGRESS, 2D SESSION (1978)

Reasons for change

The committee believes that the treatment of employer-provided educational assistance under present law occasionally gives rise to inequitable administration, adds to the complexity of the tax system, and can act as a disincentive to continuing education, particularly among those at the lower end of the economic scale.

Because ambiguities exist in the "improve or maintain skills" test imposed under present law, the taxability of educational assistance programs of particular employers necessarily depends on IRS agents' case-by-case analyses of the skills needed for the jobs held by each employee participating in such programs.

The "job-related" distinction is often both ambiguous and restrictive. For example, if a person with little or no work experience is employed in an entry-level position and receives training from his employer to advance to a job requiring some greater skills or experience, the value of the training may be taxable. This may discourage self-improvement. If a typist, for example, receives training to be a secretary, or if a secretary receives training in a paralegal program, it might be considered not job-related. Also, if a clerical employee receives computer training, it may be treated as not job-related, even though the employee's job may require computer skills in the future because of normal advances in business technology.

However, the higher the level of job held by an employee, the greater the variety courses or training likely to qualify as related to the employee's job. The committee believes that the unfairness of this anomalous result should be eliminated.

The committee also intends to reduce to the complexity of present law in this area. Not only must the Internal Revenue Service use valuable personnel time in making determinations of taxability, but employees and employers also must justify their positions. The employer also must determine whether income tax withholding and employment taxes apply to reimbursement.

More serious even than the potential inequities of administration and the complexities of the tax law is the disincentive to upward mobility. Although most citizens recognize the need to provide greater access to educational and economic opportunity to those who have had limited access in the past, the tax law presently requires out-of-pocket tax payments for employer-provided educational assistance from those least able to pay, even though they receive only services, not an increased paycheck.

Therefore, the committee provides an exclusion for employer-provided educational assistance. To avoid abuse of this expanded tax-free treatment of educational assistance, the bill limits the exclusion to benefits provided to employees and provides antidiscrimination rules.

I

98TH CONGRESS
1ST SESSION

H. R. 2831

To amend the Internal Revenue Code of 1954 to allow a disaster loss deduction with respect to a taxpayer's residence for losses which occur where the taxpayer is ordered to demolish or relocate such residence because of the danger of mudslides, earthslides, or flooding.

IN THE HOUSE OF REPRESENTATIVES

APRIL 28, 1983

Mr. PANETTA introduced the following bill; which was referred to the Committee on Ways and Means

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A BILL

To amend the Internal Revenue Code of 1954 to allow a disaster loss deduction with respect to a taxpayer's residence for losses which occur where the taxpayer is ordered to demolish or relocate such residence because of the danger of mudslides, earthslides, or flooding.

Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled,

SECTION 1. DISASTER LOSS DEDUCTION ALLOWED FOR RESIDENCES IN DISASTER AREAS WHERE TAXPAYER ORDERED TO DEMOLISH OR RELOCATE RESIDENCE BECAUSE OF DANGER OF MUDSLIDES, EARTHSLIDES, OR FLOODING.

(a) GENERAL RULE.—Section 165 of the Internal Revenue Code of 1954 (relating to losses) is amended—

(1) by redesignating subsection (k) as subsection (l), and

(2) by adding after subsection (j) the following:

"(k) TREATMENT AS DISASTER LOSS WHERE TAXPAYER'S RESIDENCE IS IN DISASTER AREA AND TAXPAYER, BECAUSE OF DANGER OF MUDSLIDES, EARTHSLIDES, OR FLOODING, IS ORDERED TO DEMOLISH OR RELOCATE SUCH RESIDENCE.—

"(1) IN GENERAL.—In the case of a taxpayer whose residence is located in an area which has been determined by the President of the United States to warrant assistance by the Federal Government under the Disaster Relief Act of 1974, if—

"(A) within 120 days after the date of such determination, the taxpayer is ordered, by the government of the State or any political subdivision thereof in which such residence is located, to demolish or relocate such residence, and

"(B) such order is based on a determination that there is a danger of mudslides, earthslides, or flooding,

then any loss attributable to such order shall be treated as a loss described in subsection (i)."

SEC. 2. EFFECTIVE DATE.

The amendments made by section 1 shall apply to taxable years beginning after December 31, 1981, with respect to residences in areas determined by the President of the United States, after such date, to warrant assistance by the Federal Government under the Disaster Relief Act of 1974.

○

SUMMARY AND DESCRIPTION

PRESENT LAW

Deduction for casualty losses

The Internal Revenue Code generally does not allow a deduction for nonbusiness losses. However, taxpayers are allowed a deduction for losses not connected with a trade or business, if such losses arise from fire, storm, shipwreck, or other casualty, or from theft (sec. 165(c)(3)). The deduction is allowed only to the extent that the loss from any individual occurrence exceeds $100. Additionally, the deduction is allowed only to the extent that the total amount of casualty and theft losses sustained during the taxable year exceeds 10 percent of the taxpayer's adjusted gross income (sec. 165(h)).

Treasury regulations provide that the amount which may be deducted for a nonbusiness casualty loss is equal to the lesser of (1) the difference between the fair market value of the property immediately before the casualty and the fair market value of the property immediately after the casualty, or (2) the taxpayer's adjusted basis for the property (Treas. Reg. sec. 1.165-7(b)).

Requirement of physical damage

The courts and the Internal Revenue Service have generally allowed a deduction for nonbusiness casualty losses only where the casualty (e.g. storm, flood or earthquake) caused actual physical damage to the taxpayer's property. The decline in value of property as a result of dangerous conditions has generally been held insufficient to support a deduction.

In *Kamanski* v. *Commissioner*, 477 F.2d 452 (9th Cir. 1973), *aff'g* 29 T.C.M. 1702 (1970), the United States Court of Appeals for the Ninth Circuit held that taxpayers were not entitled to a deduction for a loss on the sale of their property following a nearby mudslide. The Court held that the decline in value of the property was not due to damage caused by the mudslide itself, but to buyers' predictions of damage from future casualties.

In Rev. Rul. 70-16, 1970-1 C.B. 36, the IRS took the position that a loss upon the sale of a residence condemned as part of the site for flood prevention construction was not a deductible casualty loss. The State legislature had established a flood prevention district because of previous flooding in the area, but the taxpayer's property had not been physically damaged by the flooding. The ruling stated that there was no proximate relationship between the flooding and the loss on the condemnation sale.

Timing of deduction

Casualty losses generally are deductible in the year in which the casualty is sustained.

Present law (sec. 165(i)) provides a special rule for determining the timing of a deduction for a loss attributable to a disaster occurring in an area subsequently determined by the President to warrant Federal assistance under the Disaster Relief Act of 1974.[1] Under this rule, the amount of the loss may, at the election of the taxpayer, be taken into account in determining the taxpayer's liability for the taxable year immediately preceding the year in which the disaster occurred. The election must apply to the entire loss sustained by the taxpayer.

The special rule regarding Federally assisted disaster areas concerns only the timing of deductions. Thus, a taxpayer residing in a disaster area must establish the existence and amount of any loss under the general principles applicable to all taxpayers.

EXPLANATION OF THE BILL

The bill would provide that a taxpayer whose residence is located in an area determined to warrant Federal assistance under the Disaster Relief Act of 1974, and who is ordered to demolish or relocate the residence because of a danger of mudslides, earthslides, or flooding, may deduct any loss attributable to the demolition or evacuation order as a casualty loss. The order to demolish or relocate the taxpayer's residence would have to be made by the State or local government within 120 days of the Federal determination. Additionally, the order would have to be based on a State or local determination of a danger of mudslides, earthslides, or flooding.

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[1] P. L. 93-288, 93d Cong., 2d Sess., May 22, 1974 (42 U.S.C. sec. 5121 *et seq.*) The Disaster Relief Act of 1974 empowers the President to declare an area affected by a disaster (storms, floods, earthquakes, etc.) either an "emergency" or a "major disaster" area. The declaration of an emergency permits the Federal government to take immediate steps to protect life, health and property, and to provide forms of emergency assistance. Where a major disaster is declared, the Federal government is authorized to provide various additional forms of assistance, including financial assistance (including grants and loans) to private parties affected by the disaster.

Amounts deductible under the bill would be subject to the timing provisions of existing law for disaster losses. Thus, at the taxpayer's election, these amounts could be deducted on the taxpayer's return for the taxable year immediately preceding the year in which the order to demolish or relocate the residence was made.

EFFECTIVE DATE

The bill would apply to taxable years beginning after December 31, 1981, with respect to areas determined after that date to warrant Federal disaster assistance.

REVENUE EFFECT

The revenue effect of this bill is not available at this time.

I

98th CONGRESS
1st Session

H. R. 3030

To amend the Revenue Act of 1978 to provide that the inclusion in gross income of certain amounts of unemployment compensation shall not apply to unemployment compensation which is payable by reason of a work stoppage in 1973 but which was not paid until 1979.

IN THE HOUSE OF REPRESENTATIVES

May 17, 1983

Mr. Schulze introduced the following bill; which was referred to the Committee on Ways and Means

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A BILL

To amend the Revenue Act of 1978 to provide that the inclusion in gross income of certain amounts of unemployment compensation shall not apply to unemployment compensation which is payable by reason of a work stoppage in 1973 but which was not paid until 1979.

Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled, That (a) subsection (d) of section 112 of the Revenue Act of 1978 (relating to taxation of unemployment compensation benefits at certain income levels) is amended to read as follows:

"(d) Effective Date.—

"(1) IN GENERAL.—Except as provided in paragraph (2), the amendments made by this section shall apply to payments of unemployment compensation made after December 31, 1978, in taxable years ending after such date.

"(2) CERTAIN DELAYED PAYMENTS NOT TAKEN INTO ACCOUNT.—The amendments made by this section shall not apply to payments of unemployment compensation—

"(A) which are made by reason of a work stoppage which began on March 19, 1973, and ended before July 19, 1973, and

"(B) which are made in 1979 after the employer's appeal to the Supreme Court of the United States was dismissed on April 2, 1979, and its petition for rehearing denied on May 21, 1979."

(b) If credit or refund of any overpayment of tax resulting from paragraph (2) of section 112(d) of the Revenue Act of 1978, as added by this Act, is prevented at any time before the close of the 1-year period beginning on the date of the enactment of this Act by the operation of any law or any rule of law (including res judicata), refund or credit of such overpayment (to the extent attributable to the application of such paragraph (2)) may, nevertheless, be made or allowed if claim therefor is filed before the close of such 1-year period.

SUMMARY AND DESCRIPTION

PRESENT LAW

Prior to the Revenue Act of 1978, unemployment compensation paid under most government programs was excludable from gross income under a series of Internal Revenue Service rulings dating from 1938.[1] Section 112 of the Revenue Act of 1978 made includible a portion of unemployment compensation benefits paid pursuant to government programs to taxpayers with other substantial income during the year (Code sec. 85).

The amount of unemployment compensation included in adjusted gross income pursuant to the 1978 legislation was limited to one-half of the excess of (1) the sum of the taxpayer's adjusted gross income, all unemployment compensation paid pursuant to government programs, and all disability income of the type eligible for exclusion from income under Code section 105(d) (now repealed), over (2) the taxpayer's base amount. The Economic Recovery Tax Act of 1981 (sec. 103(c)(1)) modified the includible amount by adding to the items in (1) above the amount allowed under the deduction for two-earner married couples. Any social security benefits otherwise included in adjusted gross income under the Social Security Amendments of 1983 are not included in adjusted gross income for purposes of determining taxable unemployment compensation.[2]

The base amount in the 1978 legislation was $25,000 in the case of a married individual filing a joint return; zero in the case of a married individual filing a separate return (unless he or she lived apart from his or her spouse for the entire taxable year); and $20,000 in the case of all other individuals. The Tax Equity and Fiscal Responsibility Act of 1982 (sec. 611) reduced the base amount for a married individual filing a joint return to $18,000, and for all other individuals (except a married individual filing a separate return) to $12,000.

The Revenue Act of 1978 provides that the unemployment compensation taxation provisions apply to payments of unemployment compensation made after 1978, in taxable years ending after 1978. Thus, benefits paid after 1978 may be subject to income tax even if attributable to periods of unemployment before 1978.

EXPLANATION OF THE BILL

The bill would amend the Revenue Act of 1978 to provide that the provisions of that Act making includible in income certain amounts of unemployment compensation would not apply to certain unemployment compensation which is payable by reason of a 1973 work stoppage, but which was not paid until 1979. The unemployment compensation benefits that would not be taken into account in determining the taxable amount of unemployment compensation are those benefits (1) paid by reason of a work stoppage which began on March 19, 1973, and ended before July 19, 1973, and (2) paid in 1979 after the employer's appeal to the U.S. Supreme Court was dismissed on April 2, 1979, and its petition for rehearing denied on May 21, 1979.

The bill would permit taxpayers who would be entitled as a result of these provisions to a credit of any overpayment or refund, but for the operation of another law or rule of law (including res judicata), nevertheless to obtain the credit or refund by filing a claim for it before the close of the one-year period beginning on the date of enactment.

The intended beneficiaries of the bill are understood to be the individuals represented or formerly represented in collective bargaining by Local (8)-901 of the Oil, Chemical, and Atomic Workers International Union, located in Marcus Hook, Pennsylvania, who were paid unemployment compensation in 1979 by reason of the 1973 work stoppage described above. The bill would be effective on enactment.

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[1] See. I.T. 3230, 1938-2 C.B. 136 (payments by a State agency out of funds received from the Federal Unemployment Trust Fund); Rev. Rul. 55-652, 1955-2 C.B. 21 (unemployment compensation payments to Federal employees by State or Federal agencies); Rev. Rul. 70-280, 1970-1 C.B. 13 (payments by a State agency out of funds received from the Federal Unemployment Trust Fund); Rev. Rul. 73-154, 1973-1 C.B. 40 (unemployment compensation payments made under the Unemployment Compensation Act of 1971); Rev. Rul. 76-63, 1976-1 C.B. 14 (unemployment compensation benefits made under the Emergency Jobs and Unemployment Assistance Act of 1974 and the Emergency Unemployment Compensation Act of 1974); Rev. Rul. 76-144, 1976-1 C.B. 17 (payments made under the Disaster Relief Act of 1974); and Rev. Rul. 76-229, 1976-1 C.B. 19 (trade readjustment allowances paid under the Trade Act of 1974).

[2] Social Security Amendments of 1983 (the Amendments), sec. 121(f)(1). The Amendments also repeal former Code sec. 105(d) and delete the reference to Code sec. 105(d) disability income in Code sec. 85 (Amendments, secs. 122(b) and 122(c)(2)).

I

98TH CONGRESS
1ST SESSION

H. R. 3096

To amend the Internal Revenue Code of 1954 to prevent certain abuses involving tax straddles and to prevent the avoidance of the accumulated earnings tax through the use of foreign corporations.

IN THE HOUSE OF REPRESENTATIVES

MAY 23, 1983

Mr. STARK introduced the following bill; which was referred to the Committee on Ways and Means

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A BILL

To amend the Internal Revenue Code of 1954 to prevent certain abuses involving tax straddles and to prevent the avoidance of the accumulated earnings tax through the use of foreign corporations.

Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled,

SECTION 1. DEFINITION OF FOREIGN INVESTMENT COMPANY.

(a) GENERAL RULE.—Paragraph (2) of section 1246(b) of the Internal Revenue Code of 1954 (defining foreign investment company) is amended to read as follows:

"(2) engaged (or holding itself out as being engaged) primarily in the business of investing, reinvesting, or trading in—

"(A) securities (as defined in section 2(a)(36) of the Investment Compamy Act of 1940, as amended),

"(B) commodities, or

"(C) any interest (including a futures or forward contract or option) in property described in subparagraph (A) or (B),

at a time when 50 percent or more of the total combined voting power of all classes of stock entitled to vote, or the total value of all classes of stock, was held directly (or indirectly through applying paragraphs (2) and (3) of section 958(a) and paragraph (4) of section 318(a)) by United States persons (as defined in section 7701(a)(30))."

(b) EFFECTIVE DATE.—The amendment made by subsection (a) shall apply to sales and exchanges (and distributions) on or after May 23, 1983, in taxable years ending on or after such date.

SEC. 2. TREATMENT OF CERTAIN DISTRIBUTIONS RECEIVED BY UNITED STATES-OWNED FOREIGN CORPORATIONS.

(a) GENERAL RULE.—Section 535 of the Internal Revenue Code of 1954 (defining accumulated taxable income) is amended by adding at the end thereof the following new subsection:

"(d) INCOME DISTRIBUTED TO UNITED STATES-OWNED FOREIGN CORPORATION RETAINS UNITED STATES CONNECTION.—

"(1) IN GENERAL.—For purposes of this part, if more than 10 percent of the earnings and profits of any foreign corporation for any taxable year—

"(A) is derived from sources within the United States, or

"(B) is effectively connected with the conduct of a trade or business within the United States,

any distribution received (directly or through 1 or more other entities) by a United States or foreign corporation out of such earnings and profits shall be treated as derived by such corporation from sources within the United States.

"(2) UNITED STATES-OWNED FOREIGN CORPORATION.—The term 'United States-owned foreign corporation' means any corporation 50 percent or more of the total combined voting power of all classes of stock entitled to vote, or the total value of all classes of stock, was held directly (or indirectly through applying paragraphs (2) and (3) of section 958(a) and paragraph (4) of section 318(a)) by United States persons (as defined in section 7701(a)(30))."

(b) EFFECTIVE DATE.—The amendment made by subsection (a) shall apply to distributions received by a United States-owned foreign corporation (within the meaning of section 535(d) of the Internal Revenue Code of 1954) on or after May 23, 1983, in taxable years ending on or after such date.

SEC. 3. TREATMENT OF OFFSETTING POSITION STOCK.

(a) GENERAL RULE.—Paragraph (1) of section 1092(d) of the Internal Revenue Code of 1954 (defining personal property) is amended by adding at the end thereof the following new sentence: "Such term also includes any offsetting position stock."

(b) DEFINITION OF OFFSETTING POSITION STOCK.—Subsection (d) of section 1092 of such Code is amended by adding at the end thereof the following new paragraph:

"(6) OFFSETTING POSITION STOCK.—The term 'offsetting position stock' means any stock of a corporation formed or availed of to take positions in personal property which offset positions taken by shareholders."

(c) EFFECTIVE DATE.—The amendments made by this section shall apply to positions established on or after May 23, 1983, in taxable years ending on or after such date.

Summary and Description

PRESENT LAW

U.S. taxation of foreign persons

Although U.S. corporations are subject to current U.S. taxation on worldwide income, foreign corporations are generally subject to U.S. taxation on only their U.S. source income and income from a U.S. business. Foreign corporations are generally exempt from U.S. taxation on foreign source income. A special rule applies, however, to income from the sale of commodities and futures contracts. Foreign corporations are taxable on their gains from the sale of commodities and futures contracts only when those sales are effectively connected with a trade or business in the United States. In general, by avoiding contacts with the United States, a company purchasing and selling commodities and futures contracts on U.S. markets may be able to avoid having a business in the United States and thus avoid U.S. tax (sec. 864(b)(2)(B)). In that event, gains from sales of commodities and futures contracts are exempt even though they have a U.S. source.

Dividends from one foreign corporation to another foreign corporation are taxable only if most of the paying foreign corporation's income from the last three years is U.S. business income, in which case the dividends are at least in part U.S. source income (sec. 861(a)(2)(B)).

Taxation of U.S. shareholders of foreign corporations

The United States generally imposes tax on the U.S. shareholder of a foreign corporation only when that shareholder receives the foreign corporation's earnings in the form of a dividend. That is, the U.S. shareholder of a foreign corporation generally may defer tax on that income until receipt of dividends.

The Subpart F provisions of the Code provide an exception to this general rule of deferral. Under these provisions, income from certain "tax haven" type activities conducted by corporations controlled by U.S. shareholders is deemed to be distributed to the U.S. shareholders and currently taxed to them before they actually receive the income in the form of a dividend. For this purpose, tax haven activities generally include gains from trading in commodities. However, the Subpart F rules apply only if more than fifty percent of the voting power in the foreign corporation is owned by U.S. persons who own (directly or indirectly) at least ten percent interests in the corporation. (Even if ownership is so concentrated that the Subpart F rules apply, the rules apply only to those U.S. persons who are considered to own ten percent or more of the voting power in the foreign corporation.)

Two similar sets of rules, the personal holding company rules and the foreign personal holding company rules, could also subject foreign corporations or their U.S. individual shareholders to current taxation on passive investment income or trading income, but these rules apply only if five or fewer U.S. individuals own (directly or indirectly) more than fifty percent in value of the stock of a foreign corporation.

The accumulated earnings tax

The accumulated earnings tax is aimed at corporations accumulating income for the purpose of avoiding tax at the shareholder level. The accumultated earnings tax (which reaches a maximum rate of 38.5%) generally applies to a U.S. or foreign corporation formed or availed of for the purpose of avoiding the U.S. income tax on shareholders by accumulating earnings at the corporate level rather than distributing earnings.

Under final and proposed Treasury Regulations, the tax does not apply to foreign source income that is not effectively connected with a U.S. trade or business. (Reg. sec. 1.532-1(c); Proposed Reg. sec. 1.532-1(c)). It may be unclear whether a foreign parent corporation and a foreign subsidiary corporation (earning U.S. source income) from which the foreign parent receives dividends are subject to this tax, however. If the subsidiary distributes all its U.S. source earnings as dividends to its parent, those dividends are generally deductible from accumulated earnings. Therefore, there may be no accumulated earnings at the level of subsidiary to which the accumulated earnings tax can apply. The parent corporation may attempt to avoid the accumulated earnings tax by having all foreign source income (such as dividends from its subsidiary) not effectively connected with a U.S. trade or business.

The Internal Revenue Service may argue in such a case that imposition of an accumulated earnings tax on the earnings of either foreign corporation is appropriate. First, the statute and the Regulations allow imposition of the accumulated earnings tax if the avoidance of tax at the shareholder level is accomplished through the use of a chain of corporations. (See Reg. sec. 1.532-1(a)(2).) Second, the Code gives the Secretary authority to disregard certain tax benefits associated with a corporation if the corporation was acquired for the principal purpose of evading or avoiding Federal income tax (sec. 269).

Marked-to-market of futures trading income

The Economic Recovery Tax Act of 1981, Public Law 97-34, adopted a marked-to-market rule for the taxation of certain commodity futures contracts (Code sec. 1256(a)). Thus, each such regulated futures contract held by a taxpayer is treated as if it were sold or otherwise liquidated for fair market value on the last business day of the year. A maximum rate of 32 percent applies to this income. U.S. taxpayers investing through a pass-through entity (such as a limited partnership) organized in the United States in such futures contracts would be subject to this marked-to-market rule.

Foreign corporations not engaged in U.S. trade or business are not subject to the marked-to-market rule.

Shareholder level tax on disposition of the investment

Code rules attempt to prevent U.S. taxpayers from repatriating earnings at the lower capital gains rates after deferring tax on those earnings abroad. Gains of a U.S. person who was a ten-percent shareholder (during a five-year period) in a controlled foreign corporation on the disposition of that corporation's stock are subject to ordinary income (dividend) treatment rather than capital gains treatment to the extent of that person's share of the post-1962 earnings and profits of the controlled foreign corporation (sec. 1248). Wide dispersal of a foreign corporation's stock ownership can avoid controlled corporation status.

Another provision, the foreign investment company provision (sec. 1246), generally applies to any foreign corporation that is either (1) registered under the Investment Company Act of 1940 or (2) engaged primarily in the business of investing or trading in securities (as generally defined in that Act) when more than 50 percent of the corporation's stock (by value or by voting power) is held (directly or indirectly) by U.S. persons. When a U.S. person disposes of stock in a foreign investment company, that person is subject to ordinary income treatment to the extent of his share of the foreign investment company's earnings and profits. A foreign corporation that does not register under the Investment Company Act avoids the first of these criteria. In addition, certain case law holds that commodities do not constitute securities for purposes of that Act, so that a company that is engaged primarily in the business of investing or trading in commodities may avoid the second criterion.

Straddles

The Code defines a staddle as offsetting positions with respect to personal property. Personal property is defined to include only property (other than corporate stock) of a type which is actively traded. A taxpayer is treated as holding offsetting positions with respect to personal property if there is a substantial reduction in the taxpayer's risk of loss from holding any position in personal property because the taxpayer holds one or more other positions with respect to personal property.

Generally, the deduction of losses on positions which are part of a straddle is limited to the amount by which such losses exceed unrecognized gains on any offsetting positions. Some taxpayers have deliberately arranged to hold offsetting positions indirectly through ownership of stock in corportions owning such positions to avoid the straddle rules. That is, they seek to deduct losses despite unrecognized gains in the hands of the corporation that offset the shareholder's losses. Generally, the corporations involved in such transactions are foreign, so as to avoid U.S. tax on their gains.

Offshore commodity funds

A mutual fund may, using some of the rules described above, attempt to defer U.S. tax and to convert trading income to capital gain through the use of two foreign corporations, one of which ("the Parent") owns all the shares of the other ("the Subsidiary"). The fund establishes and operates these foreign corporations in tax haven jurisdictions, which impose no tax on their operations.

U.S. taxation of foreign persons.—The Parent may trade in non-U.S. commodity markets (and will avoid having any U.S. source income), while the Subsidiary will trade in U.S. commodity markets (and will earn all the U.S. source income that either corporation earns). In general, by avoiding contacts with the United States, the Subsidiary may be able to avoid having a business in the United States and thus avoid U.S. tax (sec. 864(b)(2)(B)).

The Parent may be able to avoid U.S. tax because it will be a foreign corporation with no U.S. source income. Its income will consist mainly of (1) dividends from the

Subsidiary, which should not be U.S. source, and (2) gains from trading on non-U.S. commodities markets, which will result in foreign source income.

Taxation of U.S. shareholders of foreign corporations.—The fund may plan to avoid U.S. shareholder level tax on the earnings of the Parent and the Subsidiary by having the Parent distribute no dividends. Shareholders will have to dispose of their shares to receive any income.

To decontrol these corporations for purposes of the anti-tax avoidance rules including the controlled foreign corporation rules, the Parent will restict transfers of its shares, and it will attempt to spread ownership of its shares by U.S. persons among many such persons.

Accumulated earnings tax.—The fund may plan its operations so as to try to avoid the accumulated earnings tax. It may try to benefit from the general rule that the tax does not apply to foreign source income that is not effectively connected with a U.S. trade or business. This is one of the primary reasons to set up two foreign corporations (the Parent and the Subsidiary) rather than one. The parties involved will argue that the subsidiary will not be subject to the tax because it will distribute all its U.S. source earnings as dividends to the Parent. The fund will argue that there are no accumulated earnings at the level of the Subsidiary to which the accumulated earnings tax can apply. The fund plans to avoid the accumulated earnings tax at the level of the Parent by having all the Parent's income be foreign source income not effectively connected with a U.S. trade or business. The validity of these positions under current law, however, is unclear, and the Internal Revenue Service may argue that imposition of an accumulated earnings tax on the earnings of the Parent or the Subsidiary is appropriate.

To avoid potential challenges to its position on the accumulated earnings tax, the fund may allege that its corporate structure has no tax avoidance purpose. The issue would be one of intent.

Marked-to-market of futures trading income

U.S. investors in such a fund could avoid the marked-to-market rule by interposing foreign corporations between themselves and the investments.

Shareholder level tax on disposition of the investment

Under this plan, the shareholder realizes income from investment by selling the interest in the offshore corporation rather than by being paid the earnings. A major element in this plan is to permit U.S. investors in the pool to realize capital rather then ordinary gain from their investment when they sell. Such treatment would circumvent the Code's rules that attempt to prevent U.S. taxpayers from repatriating earnings at the lower capital gains rates after deferring tax on those earnings abroad. The fund would plan to avoid this rule by causing such wide dispersal of the Parent's stock ownership as to avoid controlled foreign corporation status.

The fund would plan to avoid the foreign investment company provision (sec. 1246) by failing to register the Company or the Subsidiary under the Investment Company Act and by relying on case law that holds that commodities do not constitute securities for purposes of that Act.

EXPLANATION OF THE BILL

Definition of foreign investment company

The bill would supplement the definition of "foreign investment company" (sec. 1246), on sales of shares of which U.S. persons treat gain as ordinary rather than capital. A foreign investment company would include any foreign corporation that is engaged (or holding itself out as being engaged) primarily in the business of investing, reinvesting, or trading in securities, commodities, or any interest (including a futures or forward contract or option) in commodities or securities, at a time when 50 percent or more of the total combined voting power of all classes of stock entitled to vote, or the total value of all classes of stock, was held directly or indirectly by U.S. persons. For this purpose, "securities" are defined in section 2(a)(36) of the Investment Company Act of 1940, as amended. The main effect of this provision is to bring commodity trading companies within the definition of foreign investment company. The bill would generally not affect the treatment of foreign corporations registered under the 1940 Act.

Effective date.—This provision would apply to sales and exchanges (and distributions) on or after May 23, 1983.

Extension of accumulated earnings tax to U.S.-owned foreign corporations

The bill would make it clear that U.S. persons could not use two or more tiers of foreign corporations to avoid the accumulated earnings tax on certain U.S. earnings.

For purposes of the accumulated earnings tax rules (secs. 531-537), if more than 10 percent of the earnings and profits of any foreign corporation for any taxable year is derived from sources within the United States or is effectively connected with the conduct of a trade or business within the United States, then any distribution received (directly or indirectly) by a United States-owned[1] foreign corporation out of those earnings and profits would be treated as derived by the receiving corporation from sources within the United States. That is, the earnings retain their U.S. source or U.S. connection in the hands of the receiving (upper-tier) corporation, so the accumulated earnings tax can apply to it.

The bill defines the term "United States-owned foreign corporation" to mean any corporation if 50 percent or more of the total combined voting power of all classes of stock entitled to vote, or total value of all classic of stock, is held directly or indirectly by U.S. persons. The bill would apply only to foreign corporations. It would apply to closely held and publicly held foreign corporations alike.

Effective date.—This provision would apply to distributions received by a United States-owned foreign corporation on or after May 23, 1983.

Treatment of offsetting position stock

The bill would expand the definition of personal property, for purposes of the straddle rules (sec. 1092), to include offsetting position stock. It would define offsetting position stock to mean any stock of a corporation formed or availed of to take positions in personal property which offset positions taken by shareholders. This rule would apply to both U.S. and foreign corporations. Therefore, a taxpayer would be required to defer losses if offsetting position stock contained unrealized gains for him or her.

Effective date.—This provision would apply to positions established after May 23, 1983.

EFFECTIVE DATE

The effective dates for the provisions of the bill are included above in the "Explanation of the bill."

REVENUE EFFECT

The revenue effect of this bill is not available at this time.

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[1] The printed bill indicates this treatment for a "United States or foreign corporation." This reference in the printed bill is a typographical error.

I

98TH CONGRESS
1ST SESSION

H. R. 3173

To amend the Internal Revenue Code of 1954 to provide for the application of cash or deferred arrangement rules to money purchase plans.

IN THE HOUSE OF REPRESENTATIVES

MAY 26, 1983

Mr. MATSUI introduced the following bill; which was referred to the Committee on Ways and Means

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A BILL

To amend the Internal Revenue Code of 1954 to provide for the application of cash or deferred arrangement rules to money purchase plans.

Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled,

SECTION 1. GENERAL RULE.

Subsection (k) of section 401 of the Internal Revenue Code of 1954 (relating to cash or deferred arrangements) is amended—

(1) by adding at the end of paragraph (1) the following new sentence: "A money purchase pension plan shall not be considered as not satisfying the require-

ments of subsection (a) merely because the plan includes a qualified salary reduction arrangement.",

(2) by inserting after "arrangement" in paragraph (3)(A) the following: "under a profit-sharing or stock bonus plan, or a qualified salary reduction arrangement under a money purchase pension plan,", and

(3) by adding at the end thereof the following new paragraph:

"(5) QUALIFIED SALARY REDUCTION ARRANGEMENT.—

"(A) IN GENERAL.—A qualified salary reduction arrangement is an arrangement, under a money purchase pension plan—

"(i) under which a covered employee may elect to have the employer make payments as contributions to a trust under the plan on behalf of the employee, or to the employee directly in cash, and

"(ii) which provides that an employee's right to his accrued benefit derived from employer contributions made to the trust pursuant to his election is nonforfeitable.

"(B) MONEY PURCHASE PENSION PLAN.—For purposes of this subsection, the term 'money purchase pension plan' means a pension plan—

"(i) which is a defined contribution plan (as defined in section 414(i)),

"(ii) which was in existence on June 27, 1974, and which, on that date, included a salary reduction arrangement, and

"(iii) under which neither the employee contributions nor the employer contributions may exceed the levels provided for by the contribution formula in effect under the plan on that date."

SEC. 2. TAXABILITY OF BENEFICIARIES.

Paragraph (8) of section 402(a) of the Internal Revenue Code of 1954 (relating to cash or deferred arrangements) is amended by inserting after "(as defined in section 401(k)(2))" the following: ", or a qualified salary reduction arrangement under a money purchase pension plan (as defined in section 401(k)(5)),".

SEC. 3. CONFORMING AMENDMENTS.

(a) The caption of subsection (k) of section 401 of the Internal Revenue Code of 1954 is amended by inserting "; QUALIFIED MONEY PURCHASE PENSION PLAN" after "ARRANGEMENTS".

(b) The caption of paragraph (8) of section 402(a) of such Code is amended by inserting "; QUALIFIED MONEY PURCHASE PENSION PLAN" after "ARRANGEMENTS".

SEC. 4. EFFECTIVE DATE.

(a) In General.—The amendments made by section 1 shall apply with respect to taxable years beginning after December 31, 1980. The amendment made by section 2 shall apply with respect to contributions made after that date. The amendments made by section 3 shall take effect on the date of enactment of this Act.

(b) Transition Rule.—Any contribution made after December 31, 1979, and before the first day of the first plan year beginning after December 31, 1980, to a trust under a plan which includes a salary reduction plan or arrangement described in section 2006(b)(2) of the Employee Retirement Income Security Act of 1974 shall be treated as made to a trust which is part of a plan which includes a qualified salary reduction arrangement (as defined in section 401(k)(5) of the Internal Revenue Code of 1954), whether or not the trust to which the contribution is made meets the requirements of section 401(k)(5) of such Code, and section 135(c)(2) of the Revenue Act of 1978 shall apply in respect of such a contribution under any pension plan.

Summary and Description

PRESENT LAW

In general

A money purchase pension plan is a defined contribution plan under which each participant's pension benefit is based solely on the balance of the participant's account, consisting of contributions, income, gain, expenses, and losses. Profit-sharing plans are also defined contribution plans.

Under a cash or deferred profit-sharing plan, or under a money purchase pension plan with a salary reduction arrangement, the employer gives an employee the choice of (1) receiving a specified amount in cash as current compensation or (2) having that amount contributed by the employer to the plan.

In December 1972, the Internal Revenue Service issued proposed regulations which called into question the tax treatment of cash or deferred profit-sharing plans and money purchase pension plans with salary reduction arrangements. (These proposed regulations were withdrawn in July, 1978.) Under the rules in effect at the time of the proposal, an employee generally was not taxed currently on amounts the employee chose to have contributed to a tax-qualified cash or deferred profit-sharing plan or salary reduction money purchase pension plan. Under the proposed regulations, amounts contributed to a plan by the employer due to the election of the employee would be included in the employee's income.

Freeze on tax treatment

In order to allow time for Congressional study of this area, the Employee Retirement Income Act of 1974 (ERISA) provided that the tax treatment of contributions of cash or deferred profit-sharing plans or salary reduction money purchase plans in existence on June 27, 1974, was to be governed under the law as it was applied prior to January 1, 1972. Accordingly, employer contributions to these cash or deferred profit-sharing plans were not includible in the income of covered employees, provided the plans satisfied the requirements of pre-1972 law and otherwise complied with the tax-qualifications rules. Under ERISA, this freeze in tax treatment was continued through 1976, or (if later) until regulations were issued in final form which would change the pre-1972 administration of the law. The freeze was subsequently extended through 1979.

Revenue Act of 1978

The Revenue Act of 1978 provided rules for new and old profit-sharing plans with cash or deferred arrangements. The new rules, which also apply to stock bonus plans, are effective for plan years beginning after 1979. For years beginning before 1980, the tax treatment under a plan in existence on June 27, 1974, is determined under prior law. No new rules were provided by the 1978 Act for salary reduction arrangements under money purchase pension plans.

EXPLANATION OF THE BILL

The bill would revise the tax-qualification rules to permit a qualified money purchase pension plan which was in existence on June 27, 1974, and which provided for a salary reduction arrangement on that date, to continue the arrangement after 1979. However, the revision to the tax-qualification rules would apply only to those money purchase pension plans under which employer and employee contributions may not exceed the limits (*e.g.* the percentage of pay) provided under the plan's contribution formula on June 27, 1974.

In addition, for plan years beginning after 1979, a salary reduction arrangement under a money purchase pension plan must meet the special tax-qualification rules for cash or deferred arrangements added by the 1978 Revenue Act with respect to employee eligibility to participate in the arrangement and to prohibited discrimination in favor of employees who are officers, shareholders, or highly compensated. These rules, presently appy to cash or deferred arrangements under qualified profit-sharing or stock bonus plans.

The provisions of the bill would apply to salary reduction arrangements under money purchase pension plans of taxable employers and tax-exempt organizations.

EFFECTIVE DATE

The bill would apply retroactively for plan years beginning after December 31, 1980, and to contributions made after that date. A transition rule would be provided for contributions made after 1979, and before the beginning of the first plan year beginning after 1980.

REVENUE EFFECT

It is estimated that the bill would have a negligible effect on budget receipts.

PRIOR CONGRESSIONAL ACTIONS

An identical bill, H.R. 4948, passed the House in the 97th Congress and was included as a committee amendment to H.R. 4577 as ordered reported by the Senate Committee on Finance H.R. 4577 was not approved by the Senate.

STATEMENT OF JOHN S. NOLAN, MILLER & CHEVALIER, CHARTERED, ON BEHALF OF HAND & ASSOCIATES, AND THE THIRD FARM CREDIT DISTRICT OF COLUMBIA, S.C.

I am John S. Nolan, member of the law firm of Miller & Chevalier, Chartered. I am submitting this statement in favor of H.R. 3173—an important bill which would permit certain money purchase pension plans to qualify as cash or deferred arrangements under § 401(k) of the Internal Revenue Code and, in so doing, correct a clear oversight in the tax laws. The two clients on whose behalf I submit this statement are Hand and Associates of Houston, Texas and the Third Farm Credit District of Columbia, South Carolina.

Hand and Associates is an employee benefits consulting firm which renders professional services to hundreds of pension and profit sharing plans all over the country. Many of the plans which Hand serves are money purchase pension plans maintained by employers located principally in the South and Southwest. These employers are, for the most part, small business employing less than 20 employees. Collectively, these plans cover almost 3500 employees.

The Third Farm Credits District, one of Hand and Associates' largest clients, maintains a money purchase pension plan known as the Farm Credit Employee Thrift Plan—Columbia District. That plan includes employees of the Federal Land Bank, Federal Intermediate Credit Bank, Columbia Bank for Cooperatives and, in addition, has been adopted by scores of federal land bank associations and production credit associations in the Farm Credit System's Third District (which includes North Carolina, South Carolina, Georgia and Florida). Many of the organizations in the Farm Credit System are tax-exempt organizations under § 501(c)(1) of the Code. The Third District's money purchase pension plan covers approximately 1500 employees.

Money purchase pension plans have for years been attractive to tax-exempt organizations and small businesses or stock bonus plans and were unable to assume the substantial commitment necessitated by a defined benefit pension plan. A money purchase pension plan allows the employer to fund an employee's pension by making fixed contributions (usually based upon a specified percentage of the employee's compensation) to an account established for the employee under the plan. The name "money purchase" has been affixed to these plans because the pension benefit is determined by the annuity which the money available in the employee's account would purchase at retirement.

H.R. 3173 relates to money purchase pension plans funded, in whole or in part, by "salary reduction" contributions. The Third District's money purchase pension plan operates on a salary reduction basis and its provisions are typical of most salary reduction money purchase plans. Under the Third District's plan, an employee is required to contribute six percent of his annual compensation in order to participate in the plan. The employee's contribution is made in accordance with a salary reduction agreement which the employee voluntarily executes prior to the year in which the compensation is to be paid. The agreement is irrevocable for the entire year and may be renewed in subsequent years at the employee's option. The employer supplements the employee's salary reduction contribution with a matching contribution of three percent of the employee's compensation. In our experience, we have found a fifty percent employer contribution to be fairly common, but in many cases, employers match the salary reduction contributions at a 100 percent level.

Under the Third District's plan, the employee is always fully vested in his salary reduction contributions. Vesting in the employer matching contributions occurs at the rate of twenty percent per year. Inasmuch as the Third District's plan, like all money purchase pension plans, is qualified as a "pension plan" under Code section 401(a), participating employees are denied the right to make in-service withdrawals from their respective account balances. Rather, their account balances are available only upon separation from service, disability, or death.

H.R. 3173 would correct an unfortunate oversight which occurred when the Revenue Act of 1978 (Public Law 95-600) was enacted. That Act added § 401(k) to the Internal Revenue Code. Section 401(k) permits cash or deferred arrangements to qualify under § 401(a) and to operate without concern for the constructive receipt doctrine. The 1978 Act made cash or deferred arrangements available only with respect to profit sharing plans and stock bonus plans, however. Pension plans, which are a distinct generic category under § 401(a), were not mentioned in the legislation, with the result that a salary reduction money purchase plan may not now qualify as a cash or deferred arrangement under § 401(k).

We submit that Congress always intended to cover salary reduction money purchase plans in specific legislation. Section 2006 of ERISA precluded Treasury from issuing final regulations with respect to such plans prior to a deadline date specified in the statute. Although Congress believed that it set the deadline far enough into the future to give it adequate time to study the matter, it was compelled to extend the deadline twice thereafter. The Revenue Act of 1978 was enacted before the expiration of the last deadline, and, without explanation, that Act did not extend the § 401(k) rules to salary reduction money purchase pension plans.

Under § 401(k), an employee may elect to have a portion of his compensation to a profit sharing or stock bonus plan, and the amount so contibuted would not be considered as included in his gross income. The Internal Revenue Service has indicated in proposed regulations that such contributions may be made pursuant to salary reduction agreements. If H.R. 3173 is not enacted, the Internal Revenue Service will tax an employee's salary reduction contributions to a money purchase plan and thereby treat such contributions differently from similar contributions made to cash or deferred arrangements under § 401(k). In proposed regulations issued on November 10, 1981 (46 Fed. Reg. 55544), the Service announced that contributions made to any plan, under an arrangement whereby the employee has the option to take an amount in cash or contibute it to a plan, will be taxable as gross income if the plan does not qualify under § 401(k). Inasmuch as a money purchase pension plan cannot qualify under § 401(k), the proposed rule of the Service would result in taxable income to all employees who participate in salary reduction money purchase plans. This would be an unsound and unfair result. To make matters worse, the Service's income inclusion rule would apply retroactively to all contributions made after December 31, 1979.

H.R. 3173 would correct this unfortunate result by allowing certain qualified money purchase plans to enjoy the same protections and tax advantages afforded to profit sharing and stock bonus plans under § 401(k). This bill would amend § 401(k) to provide that a salary reduction money purchase pension plan may qualify as a cash or deferred arrangement under § 401(k) if: (1) the plan was in existence on June 27, 1974 (which is the date specified in the "grandfather rule" in § 2006 of ERISA); and (2) the plan has not, since that date, increased the level of employer or employee contributions provided for under the plan contribution formula. H.R. 3173 would also amend Code § 402(a)(8) to provide protection from the constructive receipt doctrine to a money purchase plan which meets the foregoing new requirements in § 401(k).

The Subcommittee is no doubt aware that the provisions of H.R. 3173 have, in earlier years, been approved by both the House and the Senate. In December 1980, the Senate adopted H.R. 5391—a bill which included the money purchase plan provisions that now appear in H.R. 3173. In conference, the House conferees chose not to approve the money purchase plan provisions of H.R. 5391 for the sole reason that the House had not held hearings on the provisions prior to their consideration by the Senate (Cong. Rec. H. 12469, December 13, 1980, remarks of Mr. Conable and Mr. Ullman). Treasury did not oppose the provisions of H.R. 5391 that related to money purchase plans. In September, 1982, the House passed H.R. 4948, a bill idential to H.R. 5391. Treasury supported H.R. 4948.

There is no reason to treat salary reduction money purchase plans differently from other plans which qualify now as cash or deferred arrangements under § 401(k). Congress expressed its desire in ERISA, and more recently, in H.R. 5391 and H.R. 4948, to grant certain money purchase plans the same treatment as is currently available to profit sharing and stock bonus plans. On behalf of Hand and Associates, and the more than 1500 employees participating in the Farm Credit plan for the Third District, I strongly urge you to report H.R. 3173 favorably.

98TH CONGRESS
1ST SESSION

H. R. 3529

To amend the Internal Revenue Code of 1954 with respect to the tax treatment of regulated investment companies.

IN THE HOUSE OF REPRESENTATIVES

JULY 12, 1983

Mrs. KENNELLY introduced the following bill; which was referred to the Committee on Ways and Means

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A BILL

To amend the Internal Revenue Code of 1954 with respect to the tax treatment of regulated investment companies.

Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled,

SECTION 1. (a) Subsection (a) of section 851 of the Internal Revenue Code of 1954 (defining regulated investment company) is amended by striking out "(other than a personal holding company as defined in section 542)".

(b) Paragraph (1) of section 852(b) of such Code (relating to imposition of tax on regulated investment companies) is amended by adding at the end thereof the following new sentence: "In the case of a regulated investment company which is a personal holding company (as defined in section 542), the tax shall be computed at the highest rate of tax specified in section 11(b)."

(c) Subsection (a) of section 852 of such Code (relating to requirements applicable to regulated investment companies) is amended by striking out "and" at the end of paragraph (1), by striking out the period at the end of paragraph (2) and inserting in lieu thereof ", and", and by adding at the end thereof the following new paragraph:

"(3) in the case of an investment company which is a personal holding company, either—

"(A) the provisions of this part have been applicable to the investment company for all taxable years ending on or after June 30, 1983; or

"(B) the investment company has no earnings and profits accumulated in any taxable year in which such provisions (or the corresponding provisions of prior law) were not applicable to it."

(d) The amendments made by this section shall apply to taxable years beginning after December 31, 1982.

SEC. 2. (a) Paragraph (2) of section 852(b) of the Internal Revenue Code of 1954 (defining investment company taxable income) is amended by adding at the end thereof the following new subparagraph:

"(F) The taxable income shall be computed without regard to section 454(b) (relating to short-term obligations issued on a discount basis) if the company so elects in a manner prescribed by the Secretary."

(b) The amendment made by this section shall apply to taxable years beginning after December 31, 1978.

SEC. 3. For purposes of applying the amendments made by section 547 of the Highway Revenue Act of 1982 and the amendment made by section 202(b)(2) of Public Law 97–473, Public Law 97–473 shall be deemed to have been enacted immediately before the Highway Revenue Act of 1982.

SUMMARY AND DESCRIPTION

PRESENT LAW

General rules

In general.—Under present law, a regulated investment company (RIC) is treated, in essence, as a conduit for tax purposes. If a corporation qualifies as a RIC, it is allowed a deduction for dividends paid to its shareholders. In order for a corporation to be a RIC, it must meet several requrements.

First, a RIC must be a domestic corporation which (1) at all times during the taxable year is registered under the Investment Company Act of 1940, as amended, either as a management company or as a unit investment trust, or (2) is a common trust fund that meets certain requirements.[1]

Second, the corporation must elect RIC status for the taxable year (or must have made such an election for a previous taxable year).

Third, the corporation must not be a personal holding company for the taxable year.

Fourth, the corporation must meet certain gross income and distribution requirements. In general, at least 90 percent of the corporation's gross income must be derived from dividends, interest, certain payments with respect to securities loans, and gains from the sale or other disposition of stock or securities. In addition, less than 30 percent of its gross income can be derived from the sale or other disposition of stock or securities sold for less than three months and, at the close of any quarter, at least 50 percent of its total assets must be represented by cash, cash items, government securities, government securities of other RICs, and certain other securities. Not more than 25 percent of the value of the total assets of the corporation can be invested in securities (other than government securities or securities of other RICs) of any one issuer, or of two or more issuers controlled by the taxpayer and determined to be engaged in the same, similar or a related trade or business.

Fifth, a RIC must distribute at least 90 percent of its investment company taxable income for the taxable year (determined, in general, without regard to the dividends paid deduction), and 90 percent of the amount of its tax exempt interest income over the deductions allocable to such exemption (and disallowed as deductions for that reason).

As indicated above, if a corporation qualifies as a RIC, it is allowed a deduction for distributions paid to its shareholders. The RIC shareholder is taxed on the amount of dividends received or deemed received. In addition, special rules apply with respect to capital gains income.

If any of the requirements for RIC status are not met for the taxable year, then the RIC is taxed as any regular corporation and is not entitled to the special RIC deduction for dividends paid.

Personal holding company.—Personal holding companies are subject to a special 50 percent tax on their undistributed personal holding company income. In general, a personal holding company is any corporation, other than certain types of corporations,[2] at least 60 percent of the adjusted ordinary gross income of which is dividends, interest, rents, royalties, or other types of passive income. In addition, at any time during the last half of the taxable year, 50 percent or more of the value of the corporation's outstanding stock must be owned (directly or indirectly) by or for not more than five individuals.[3]

Accounting for short-term government obligations

In the case of any short-term obligaton of the United States, a State, or any possession of the United States, of any political subdivision of the foregoing, or of the District of Columbia issued at a discount and redeemable at maturity without interest, the amount of the original discount sale price is deemed to accrue at the earlier of the date the obligation is paid at maturity, or the date the obligation is sold or otherwise disposed of. For this purpose, an obligation is a short-term obligation if it has a fixed maturity date not exceeding one year from the date of issue. Thus, with respect to such obligations, accrual-basis taxpayers are not taxable on the discount until the obligation matures.

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[1] There requirements are that the corporation be a common trust fund or similar fund excluded by section 3(c)(3) of the Investment Company Act of 1940 from the definition of "investment company" and not included in the definition of common trust fund by Code section 584(a).

[2] The corporations excluded from the definition of personal holding company include tax-exempt corporations, banks, savings and loans, life insurance companies, certain lending or finance companies, certain foreign held corporations, and small business investment companies.

[3] For this purpose, a trust created or organized in the United States and forming part of a qualified stock bonus, pension, or profit sharing plan and certain private foundations are included in the definition of individual.

Clarification of prior statutes

The Highway Revenue Act of 1982 revised Code section 103(m) to clarify that interest on certain obligations is tax-exempt under section 103 and that, therefore, the shareholders of RICs holding such obligations qualify for tax-free treatment on the distributions of the interest on such obligations. Public Law 97-473 also revised old section 103(m) to provide cross references. Because the Highway Act was signed prior to Public Law 97-473, a question arises as to whether the provision relating to Code section 103(m) contained in the Highway Act was repealed by the later-signed law.

EXPLANATION OF THE BILL

Closely held RICs

Under the bill, the limitation in the definition of regulated investment companies (RICs) which disallows RIC status to any corporation that is also a personal holding company would be repealed. Therefore, a RIC could also be a personal holding company (that is, a RIC could be held by five or fewer individuals). However, in the case of any RIC which was closely held, any undistributed investment company taxable income of the RIC for that taxable year would be taxed using the highest rate of corporate tax specified in the Code. This tax would be in addition to any personal holding company tax that also applied.[4]

Further, a corporation which is a personal holding company would not be taxable as a RIC unless, in addition to the other requirements under the Code either (1) the investment company was subject to the RIC provisions of the Code for all taxable years ending on or after June 30, 1983, or (2) the investment company had no earnings and profits accumulated in any taxable year in which the RIC provisions of the Code were not applicable to it.

Accounting for short-term government obligations

The bill provides that the original market discount accruing with respect to any short-term government obligation would be taxable to the RIC as it accures, if the company so elects in a manner prescribed by the Internal Revenue Service. This provision would permit RICs to conform the income tax accounting rules for short-term government obligations with the book accounting method required by the Securities and Exchange Commission.

Clarification of prior statutes

Finally, the bill clarifies that Public Law 97-473 did not repeal the exempt interest provision added by the Highway Revenue Act of 1982.

EFFECTIVE DATE

The definitional provisions of the bill would be effective for taxable years beginning after 1982. The amendment with respect to the accrual of short-term government discount income would be effective retroactively with respect to taxable years beginning after 1978.

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[4] The personal holding company tax would apply in most cases other than RICs also qualifying as small business investment companies, and certain other exceptions.

98TH CONGRESS
1ST SESSION

H. R. 3592

To amend the Internal Revenue Code of 1954 to permit the rollover of certain partial distributions from qualified plans, and for other purposes.

IN THE HOUSE OF REPRESENTATIVES

JULY 19, 1983

Mr. ROSTENKOWSKI (for himself and Mr. CONABLE) introduced the following bill; which was referred to the Committee on Ways and Means

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A BILL

To amend the Internal Revenue Code of 1954 to permit the rollover of certain partial distributions from qualified plans, and for other purposes.

Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled,

SECTION 1. AMENDMENT OF 1954 CODE.

Except as otherwise expressly provided, whenever in this Act an amendment or repeal is expressed in terms of an amendment to, or repeal of, a section or other provision, the reference shall be considered to be made to a section or other provision of the Internal Revenue Code of 1954.

SEC. 2. ROLLOVER OF CERTAIN PARTIAL DISTRIBUTIONS PERMITTED.

(a) GENERAL RULE.—

(1) QUALIFIED TRUSTS.—Clause (i) of section 402(a)(5)(A) (relating to rollover amounts) is amended to read as follows—

"(i) any portion of the balance to the credit of an employee in a qualified trust is paid to him,".

(2) QUALIFIED ANNUITIES.—Clause (i) of section 403(a)(4)(A) of such Code (relating to rollover amounts) is amended to read as follows:

"(i) any portion of the balance to the credit of an employee in an employee annuity described in paragraph (1) is paid to him,".

(3) SECTION 403(b) ANNUITIES.—Clause (i) of section 403(b)(8)(A) of such Code (relating to rollover amounts) is amended to read as follows:

"(i) any portion of the balance to the credit of an employee in an annuity contract described in paragraph (1) is paid to him,".

(b) SPECIAL RULES FOR ROLLOVERS OF PARTIAL DISTRIBUTIONS.—Paragraph (5) of section 402(a) of such Code is amended by redesignating subparagraphs (D) and (E) as subparagraphs (E) and (F), respectively, and by inserting after subparagraph (C) the following new subparagraph:

"(D) SPECIAL RULES FOR PARTIAL DISTRIBUTIONS.—

"(i) REQUIREMENTS.—Subparagraph (A) shall apply to a partial distribution only if—

"(I) such distribution is of an amount equal to at least 50 percent of the balance to the credit of the employee in a qualified trust (determined immediately before such distribution and with regard to subsection (e)(4)(C)),

"(II) such distribution is not one of a series of periodic payments, and

"(III) the employee elects (at such time and in such manner as the Secretary shall by regulations prescribe) to have subparagraph (A) apply to such partial distribution.

"(ii) PARTIAL DISTRIBUTIONS MAY BE TRANSFERRED ONLY TO INDIVIDUAL RETIREMENT PLANS.—In the case of a partial distribution, a plan described in subclause (IV) or (V) of subparagraph (E)(iv) shall not be treated as an eligible retirement plan.

"(iii) DENIAL OF 10-YEAR AVERAGING AND CAPITAL GAINS TREATMENT FOR SUBSEQUENT DISTRIBUTIONS.—If an election under clause (i) is made with respect to any partial distribution paid to any employee—

"(I) paragraph (2) of this subsection,

"(II) paragraphs (1) and (3) of subsection (e), and

"(III) paragraph (2) of section 403(a),

shall not apply to any distribution (paid after such partial distribution) of the balance to the credit of such employee under the plan under which such partial distribution was made (or under any other plan which, under subsection (e)(4)(C), would be aggregated with such plan).

"(iv) SPECIAL RULE FOR UNREALIZED APPRECIATION.—If an election under clause (i) is made with respect to any partial distribution, the second and third sentences of paragraph (1) shall not apply to such distribution."

(c) PARTIAL DISTRIBUTIONS PAID TO SPOUSE OF EMPLOYEE AFTER EMPLOYEE'S DEATH ELIGIBLE FOR ROLLOVER.—

(1) IN GENERAL.—Paragraph (7) of section 402(a) of such Code (relating to rollover where spouse receives lump-sum distribution at death of employee) is amended to read as follows:

"(7) ROLLOVER WHERE SPOUSE RECEIVES DISTRIBUTIONS AFTFR DEATH OF EMPLOYEE.—If any distribution attributable to an employee is paid to the spouse of the employee after the employee's death, paragraph (5) shall apply to such distribution in the same manner as if the spouse were the employee."

(2) ESTATE TAX TREATMENT.—Subsection (e) of section 2039 of such Code (relating to exclusion of individual retirement accounts, etc.) is amended by striking out "section 402(a)(5)" and inserting in lieu thereof "section 402(a)(5) (without regard to section 402(a)(7))".

(d) TECHNICAL AND CONFORMING AMENDMENTS.—

(1) The following provisions are each amended by striking out "qualifying rollover distribution" each place it appears and inserting in lieu thereof "qualified total distribution"—

(A) section 402(a)(5)(B),

(B) section 402(a)(5)(E)(i) (as redesignated by subsection (b)), and

(C) section 402(a)(6)(E)(i).

(2) Subparagraph (B) of section 402(a)(5) is amended by adding at the end thereof the following new sentence: "In the case of any partial distribution, the maximum amount transferred to which subparagraph (A) applies shall not exceed the portion of such distribution which is includible in gross income (determined without regard to subparagraph (A))."

(3) Clause (ii) of section 402(a)(5)(E) (as redesignated by subsection (b)) is amended by striking out "gross income" and inserting in lieu thereof "gross income (determined without regard to this paragraph)".

(4) Clause (v) of subparagraph (E) of section 402(a)(5) (as redesignated by subsection (b)) is amended to read as follows:

"(v) PARTIAL DISTRIBUTION.—The term 'partial distribution' means any distribution to an employee of any portion of the balance to the credit of such employee in a qualified trust; except that such term shall not include any distribution which is a qualified total distribution."

(5) Subparagraph (F) of section 402(a)(5) (as redesignated by subsection (b)) is amended by striking

out "subparagraph (D)(iv)" each place it appears and inserting in lieu thereof "subparagraph (E)(iv)".

(6) Paragraph (6) of section 402(a) is amended by striking out "paragraph (5)(D)(i)" each place it appears and inserting in lieu thereof "paragraph (5)(E)(i)".

(7) Clauses (iii) and (iv) of section 402(a)(6)(D) are each amended by striking out "employee contributions" and inserting in lieu thereof "employee contributions (or, in the case of a partial distribution, the amount not includible in gross income)".

(8) Clause (i) of section 402(a)(6)(E) is amended by striking out "paragraph (5)(D)(i)(II)" and inserting in lieu thereof "paragraph (5)(E)(i)(II)".

(9) Subparagraph (B) of section 403(a)(4) is amended by striking out "(B) through (E)" and inserting in lieu thereof "(B) through (F)".

(10) Subparagraph (B) of section 403(b)(8) is amended to read as follows:

"(B) SPECIAL RULES FOR PARTIAL DISTRIBUTIONS.—

"(i) IN GENERAL.—In the case of any distribution other than a total distribution, rules similar to the rules of clauses (i) and (ii) of section 402(a)(5)(D) shall apply.

"(ii) TOTAL DISTRIBUTION.—For purposes of subparagraph (A), the term 'total distribution' means one or more distributions from an annuity contract described in paragraph (1) which would constitute a lump-sum distribution within the meaning of section 402(e)(4)(A) (determined without regard to subparagraphs (B) and (H) of section 402(e)(4)) if such annuity contract were described in subsection (a), or 1 or more distributions of accumulated deductible employee contributions (within the meaning of section 7205).

"(iii) AGGREGATION OF ANNUITY CONTRACTS.—For purposes of this paragraph, all annuity contracts described in paragraph (1) purchased by an employer shall be treated as a single contract, and section 402(e)(4)(C) shall not apply."

(11) Subparagraph (C) of section 403(b)(8) is amended by striking out "(D)(v), and (E)(i)" and inserting in lieu thereof "(F)(i)".

(12) Clause (ii) of section 408(d)(3)(A) is amended by striking out "rollover contribution from an employee's trust" and inserting in lieu thereof "rollover con-

tribution of a qualified total distribution (as defined in section 402(a)(5)(E)(i)) from an employee's trust".

(13) Subparagraph (C) of section 409(b)(3) is amended by striking out the second sentence and inserting in lieu thereof the following new sentences: "This subparagraph does not apply in the case of a transfer to such an employees' trust or such an annuity unless no part of the value of such proceeds is attributable to any source other than a qualified rollover contribution. For purposes of the preceding sentence, the term 'qualified rollover contribution' means any rollover contribution of a qualified total distribution (as defined in section 402(a)(5)(E)(i)) which is from such an employees' trust or annuity plan (other than an annuity plan or a trust forming part of a plan under which the individual was an employee within the meaning of section 401(c)(1) at the time contributions were made on his behalf under such plan), and which did not qualify as a rollover contribution by reason of section 402(a)(7)."

(e) EFFECTIVE DATE.—The amendments made by this section shall apply to distributions made after December 31, 1983, in taxable years ending after such date.

SEC. 3. ALLOWANCE OF DEDUCTION WHERE EXPENSES AND INTEREST ARE PAID TO RELATED CASH-BASIS TAXPAYERS AFTER 2½-MONTH PERIOD.

(a) In General.—Subsection (a) of section 267 (relating to losses, expenses, and interest with respect to transactions between related taxpayers) is amended to read as follows:

"(a) In General.—

"(1) Deduction for losses disallowed.—No deduction shall be allowed in respect of losses from sales or exchanges of property (other than losses in cases of distributions in corporate liquidations), directly or indirectly, between persons specified in any of the paragraphs of subsection (b).

"(2) Matching of deduction and payee income item in the case of expenses and interest.—If—

"(A) by reason of the method of accounting of the person to whom the payment is to be made, the amount thereof is not (unless paid) includible in the gross income of such person, and

"(B) at the close of the taxable year of the taxpayer for which (but for this paragraph) the amount would be deductible under sections 162, 212, or 163, both the taxpayer and the person to whom the payment is to be made are persons specified in one of the paragraphs of subsection (b),

then no deduction shall be allowed in respect of expenses otherwise deductible under section 162 or 212, or of interest otherwise deductible under section 163, before the day as of which the amount thereof is includible in the gross income of the person to whom the payment is made."

(b) CONFORMING AMENDMENT.—Subsection (e) of section 267 (relating to rule where last day of 2½-month period falls on Sunday, etc.) is hereby repealed.

(c) EFFECTIVE DATE.—The amendments made by this section shall apply to amounts allowable as deductions under sections 162, 163, and 212 of the Internal Revenue Code of 1954 for taxable years beginning after December 31, 1983. For purposes of the preceding sentence, the allowability of a deduction shall be determined without regard to any disallowance or postponement of deductions under section 267 of such Code.

SEC. 4. EXTENSION OF SECTION 267 TO CERTAIN RELATED ENTITIES.

(a) PASS-THRU ENTITIES.—Section 267 is amended by striking out subsection (f) and inserting in lieu thereof the following:

"(e) SPECIAL RULES FOR PASS-THRU ENTITIES.—

"(1) IN GENERAL.—In the case of any amount paid or incurred by a pass-thru entity, for purposes of applying subsection (a)(2)—

"(A) such entity,

"(B) in the case of—

"(i) a partnership, any person who owns (directly or indirectly) any capital interest or profits interest of such partnership, or

"(ii) an S corporation, any person who owns (directly or indirectly) 2 percent or more in value of the outstanding stock of such corporation, and

"(C) any person related (within the meaning of subsection (b) of this section or section 707(b)(1)(A)) to a person described in subparagraph (B),

shall be treated as persons specified in a paragraph of subsection (b).

"(2) PASS-THRU ENTITY.—For purposes of this section, the term 'pass-thru entity' means—

"(A) a partnership, and

"(B) an S corporation.

"(4) COORDINATION WITH SECTION 706.—In the case of any amount paid or incurred by a partnership, subsection (a)(2) shall not apply to the extent that section 706(a) applies to such amount.

"(5) CONSTRUCTIVE OWNERSHIP IN THE CASE OF PARTNERSHIPS.—For purposes of determining ownership of a capital interest or profits interest of a partnership, the principles of subsection (c) (other than paragraph (3)) shall apply."

(b) EXTENSION TO CERTAIN CONTROLLED CORPORATIONS.—Section 267 is amended by adding at the end thereof the following new subsection:

"(f) CERTAIN CONTROLLED CORPORATIONS.—

"(1) IN GENERAL.—For purposes of this section (but not for purposes of any other provision of this title which refers to this section), 2 corporations—

"(A) which are members of the same controlled group, and

"(B) which (but for this paragraph) are not persons specified in any of the paragraphs of subsection (b),

shall be treated as persons specified in a paragraph of subsection (b).

"(2) CONTROLLED GROUP.—For purposes of paragraph (1), the term 'controlled group' has the meaning given to such term by section 1563(a), except that—

"(A) 'more than 50 percent' shall be substituted for 'at least 80 percent' each place it appears in section 1563(a)(1), and

"(B) the determination shall be made without regard to subsections (a)(4) and (e)(3)(C) of section 1563."

(c) EFFECTIVE DATE.—The amendments made by this section shall apply to taxable years beginning after December 31, 1983.

SEC. 5. PREFERRED STOCK ELIGIBLE UNDER SECTION 1244.

(a) GENERAL RULE.—Subsections (c)(1) and (d)(2) of section 1244 (relating to losses on small business stock) are each amended by striking out "common stock" and inserting in lieu thereof "stock".

(b) EFFECTIVE DATE.—The amendment made by subsection (a) shall apply to stock issued after the date of the enactment of this Act in taxable years ending after such date.

SEC. 6. COORDINATION OF CERTAIN AMENDMENTS MADE BY HIGHWAY REVENUE ACT OF 1982 AND PUBLIC LAW 97-473.

For purposes of applying the amendments made by section 547 of the Highway Revenue Act of 1982 and the amendment made by section 202(b)(2) of Public Law 97-473, Public Law 97-473 shall be deemed to have been enacted immediately before the Highway Revenue Act of 1982.

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SUMMARY AND DESCRIPTION

Rollover of Certain Partial Distributions From Qualified Plans (Sec. 2 of the Bill and Sec. 402(a) of the Code)

PRESENT LAW

Under present law, an employee's benefits from or under a tax-qualified pension, profit-sharing, stock bonus plan, or a qualified annuity plan generally are includible in income when the benefits are distributed. If the balance to the credit of an employee is paid to the employee or to the surviving spouse of the employee as a qualifying rollover distribution, all or any portion of the distribution may be rolled over, within 60 days of the date of the distribution, to another qualified pension, etc., plan or an individual retirement account, annuity, or retirement bond (an IRA). If a rollover is made, tax is deferred on the portion of the distribution rolled over. Under present law, no rollover is permitted for a plan distribution that is not a total distribution.

Present law defines a qualifying rollover distribution as one or more distributions (1) within one taxable year of the employee on account of the termination of the plan or, in the case of a profit-sharing or stock bonus plan, a complete discontinuance of contributions under the plan, (2) that constitute a lump-sum distribution, or (3) that constitute a distribution of accumulated deductible employee contributions.

Similar rules apply under present law to benefits under tax-sheltered annuity contracts. Consequently, a lump-sum distribution under a tax-sheltered annuity contract also may be rolled-over, tax-free, to another tax-sheltered annuity contract or to an IRA. Tax-sheltered annuity contracts may be purchased for employees by certain tax-exempt organizations or by public educational organizations.

A distribution is a lump-sum distribution only if it consists of the balance to the credit of the employee under the qualified pension, etc., plan or tax-sheltered annuity contract, is made within one taxable year of the recipient, and is made on account of the employee's attainment of age 59½, separation from service, or death. In the case of a self-employed individual, a lump-sum distribution may be paid on account of attainment of age 59½, death, or disability.

If an employer maintains more than one qualified pension, etc., plan, present law requires that all qualified pension, etc., plans of the employer of the same type (*e.g.*, all profit-sharing plans) generally must be aggregated for purposes of determining whether the balance to the credit of the employee has been distributed in a lump sum distribution. A special exception applies solely for purposes of the rollover provisions. Consequently, if an employer maintains two qualified pension plans, one of which is a defined benefit pension plan and one of which is a money purchase pension plan, and the balance to the credit of an employee in the money purchase pension plan is distributed, the balance to the credit of the employee under the defined benefit pension plan is not counted under the aggregation rules. In the case of a tax-sheltered annuity contract, the aggregation rules provide that all tax-sheltered annuity contracts purchased for an employee by one employer are treated as a single contract for purposes of determining the balance to the credit of the employee.

Under present law, if no part of a lump sum distribution from a qualified pension, etc., plan is rolled over, it may be accorded special 10-year income averaging.[1] Also, present law provides that if a lump sum distribution includes employer securities with unrealized appreciation, the unrealized appreciation generally is not includible in gross income until the securities are sold or exchanged. This rule applies whether or not all or a portion of the distribution is rolled over to another qualified plan or to an IRA.

EXPLANATION OF THE PROVISION

Under the bill, distributions of less than the balance to the credit of an employee under a qualified pension, etc., plan, qualified annuity plan, or a tax-sheltered annuity contract could be rolled over, tax-free, by the employee (or the surviving spouse of the employee) to an IRA. A rollover of a partial distribution would be permitted only if (1) the distribution equals at least 50 percent of the balance to the credit of the employee, determined immediately before the distribution, (2) the distribution is not one of a series of periodic payments, and (3) the employee elects tax-free rollover treatment at the time and in the manner prescribed by the Secretary of the Treasury. For purposes of determining whether a distribution is at least 50 percent of the balance to the credit of the employee under a qualified pension, etc., plan or a tax-sheltered annuity contract, amounts credited under other qualified plans or tax-sheltered annuity contracts of the same employer are not counted.

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[1] Alternatively, a part of the distribution may be accorded long-term capital gain treatment. Long-term capital gain treatment also may be available with respect to a qualifying rollover distribution under a qualified annuity plan or a tax-sheltered annuity contract.

As under present law, the rollover of a partial distribution must be made within 60 days after the date of the distribution. If the employee or surviving spouse of the employee elects partial distribution rollover treatment, no portion of the distribution may be rolled over to another qualified pension, etc., plan or a tax-sheltered annuity. In addition, any subsequent distribution from the same plan (or any other plan of the employer required to be aggregated for the lump sum distribution rules) would not be eligible for the special 10-year income averaging, or long-term capital gain treatment accorded lump sum distributions and no special treatment would be accorded to net unrealized appreciation of employer securities. Similarly, if an employee elects partial distribution rollover treatment under a tax-sheltered annuity, a subsequent distribution under any other tax-sheltered annuity of the same employer would not be eligible for long-term capital gains treatment.

In the case of a rollover of a partial distribution, the maximum amount rolled over could not exceed the portion of the distribution includible in gross income. Also, amounts in IRAs could not be rolled over to a qualified pension, etc., plan or to a tax-sheltered annuity contract if the balance in the IRA consists, in part, of a rollover of a partial distribution.

EFFECTIVE DATE

The provision would be effective for distributions made after December 31, 1983, in taxable years ending after that date.

REVENUE EFFECT

It is estimated that the bill would have a negligible effect on budget receipts.

Treatment of Certain Transactions Between Related Parties (Secs. 3 and 4 of the Bill and Sec. 267 of the Code)

PRESENT LAW

Under present law, an accrual-basis taxpayer is denied a deduction for certain accrued expenses or interest owed to related persons who use the cash method of accounting (sec. 26~~7). The dis~~allowed interest and business expenses are those which are not paid to the related person within the taxable year in which the expenses accrue or within 2½ months thereafter This provision prevents an accrual-basis taxpayer from claiming a deduction for an accrued expense which the related cash-basis payee is not required to take into income until some subsequent time, if at all.

Because an accrued expense is deductible by a taxpayer under the accrual method of accounting only in the taxable year in which it accrues, a deduction disallowed under section 267(a) is permanently lost. It cannot be deducted at some subsequent time when payment is made.

Present law places a subchapter S corporation on the cash method of accounting for purposes of deducting business expenses and interest owed to a related cash-basis taxpayer, including a shareholder who owns at least two percent of the stock in the corporation. Thus, the corporation's deductions (which in the case of a subchapter S corporation are taken into account on the shareholders' returns) are allowed at the same time the income is recognized by the shareholder. Furthermore, no deductions are lost if payment is made after the 2½-month period expires. Present law does not provide a similar rule for payments between an accrual basis partnership and a cash basis partner, although present law requires that guaranteed payments made to a partner be includible in the partner's taxable year corresponding to the year the partnership deducted the payment (secs. 706(a) and 707(c)) (an accrual rule).

Finally, present law provides that no deduction is allowed for losses from sales or exchanges of property between related parties. Any gain recognized on a subsequent disposition of the property by the related party is reduced by the disallowed loss.

EXPLANATION OF PROVISION

Under the bill, an accrual-basis taxpayer would be placed on the cash method of accounting with respect to deductions of business expenses and interest owed to a related cash-basis taxpayer. Thus, the accrual-basis taxpayer would be allowed to deduct business expenses or interest owed to a related cash-basis taxpayer when payment is made (whether or not paid within 2½ months after the close of the taxable year); in other words, the deduction by the payor would be allowed only when the corresponding income is recognized by the payee.

Also, the present-law special rules relating to payments by subchapter S corporations would be extended to payments by partnerships. Thus, a partnership would not be allowed to deduct accrued business expenses or interest owed to a partner until the amounts are paid and are includible in the income of the cash-basis partner. This rule would apply to any payment made to a partner holding (actually or constructively) any capital interest or profits interest in the partnership or to any person related to a partner (within the meaning of secs. 267(b) or 707(b)(1)(A)). This cash basis rule would not apply, however, to guaranteed payments (within the meaning of sec. 707(c)) made to a partner because the present law accrual rule is continued.[2]

For example, assume that a corporation owns a one percent profits interest in partnership X and a 51-percent capital and profits interest in partnership Y. Partnership X uses the accrual method of accounting and partnership Y uses the cash method. Under the bill, unpaid interest owed by X to Y cannot be deducted by X until paid to Y, because Y is related to a partner of X by reason of section 707(b)(1)(A). If, however, the corporation has only a 40-percent interest in Y and, therefore, is not related to Y under section 707(b)(1)(A), then the new rule would not apply.

Finally, the bill would extend the loss disallowance and accrual provisions of section 267 to transactions between certain controlled corporations. For purposes of these loss disallowance and accrual provisions, corporations would be treated as related persons under the controlled corporation rules of section 1563, except that a 50-percent control test would be substituted for the 80-percent test.

EFFECTIVE DATE

The bill would apply to taxable years beginning after December 31, 1983.

REVENUE EFFECT

The revenue effect of this bill is not available at this time.

Preferred Stock Eligible for Small Business Corporation Stock Treatment (Sec. 5 of the Bill and Sec. 1244 of the Code)

PRESENT LAW

Under present law, gain or loss on the disposition of a capital asset (such as corporate stock held for investment purposes) is generally treated as capital gain or loss. A capital loss sustained by an individual first offsets any capital gain. Any excess capital losses may offset up to $3,000 of ordinary income.

Ordinary loss treatment, rather than capital loss treatment, is provided in certain cases for small business corporation stock (section 1244 stock) which is disposed of at a loss. This special treatment is accorded only to individual shareholders to whom the stock was originally issued, not to individuals who are partners in a partnership at the time the partnership acquired the stock from an issuing small business corporation and who share in a loss sustained by the partnership on the section 1244 stock.

The maximum amount of ordinary loss from the disposition of section 1244 stock that may be claimed in any taxable year is limited to $50,000 ($100,000 in the case of married taxpayers filing a joint return).

For stock to qualify as section 1244 stock, the following requirements must be met: (1) the stock must be common stock; (2) the corporation issuing the stock must be a domestic corporation; (3) the equity capital of the corporation may not exceed $1,000,000; (4) the stock must be issued for money or other property, subject to certain exceptions; and (5) the corporation must be engaged in the active conduct of a trade or business.

EXPLANATION OF PROVISION

Under the bill, the ordinary loss provisions of section 1244 would be extended to losses on preferred stock of small business corporations. All restrictions applicable under present law to losses on common stock would apply to losses on preferred stock. This provision is intended to encourage the investment of new venture capital in small, high-risk corporate ventures.

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[2] Although the language of the bill excepts all amounts to which sec. 706(a) applies, that exception was intended to refer only to the application of sec. 706(a) to guaranteed payments.

EFFECTIVE DATE

The provision would apply to stock issued after the date of enactment.

REVENUE EFFECT

It is estimated that this provision will reduce budget receipts by less than $5 million annually.

PRIOR CONGRESSIONAL ACTION

A similar provision was reported by the Ways and Means Committee in the 97th Congress as part of "The Tax Incentive Act of 1981" (H.R. 4242), but which was not approved by the House.

Coordination of Certain Amendments Made by the Highway Revenue Act of 1982 and Public Law 97-473 (Sec. 6 of the Bill)

PRESENT LAW

The Highway Revenue Act of 1982 revised Code section 103(m) to clarify that interest on certain obligations is tax exempt under section 103 and that therefore the shareholders of regulated investment companies holding those obligations qualify for tax-free treatment on the distributions of the interest on those obligations. Public Law 97-473 also revised old section 103(m) to provide cross references. Because the Highway Act was signed prior to P.L. 97-473, the question arises whether the provision relating to Code section 103(m) contained in the Highway Act was repealed by the later-signed law.

EXPLANATION OF PROVISION

The bill would clarify that Public Law 97-473 did not repeal the provision relating to tax-exempt interest added by the Highway Revenue Act.[3]

EFFECTIVE DATE

The provision would be effective upon enactment.

REVENUE EFFECT

The provision would not affect revenues.

ARNOLD & PORTER,
Washington, D.C., September 20, 1983.

Mr. JOHN J. SALMON,
Chief Counsel, Committee on Ways and Means, House of Representatives, Longworth House Office Building, Washington, D.C.

DEAR MR. SALMON: I write on behalf of several clients to call the Committee's attention to the fact that the provisions of H.R. 3592, extending the rules of section 267 of the Internal Revenue Code to certain transactions between partnerships and related parties, while effective prospectively, contain no "grandfather" rules for transactions consummated prior to the introduction of the bill.

In particular, I am aware of a number of transactions consummated prior to the introduction of the bill involving the sale of real estate by a cash basis partner to an accrual basis partnership with the seller taking back a purchase money mortgage under which some interest accrues but is not payable currently. I have no doubt that there have been many other such transactions throughout the country. These transactions were planned, and the economic burdens and benefits were structured, under the assumption that section 267 would not prevent the partnership from deducting the accrued but unpaid interest. If H.R. 3592 is enacted in its present form, then in the future such interest will not be deductible until paid, changing in many cases dramatically the tax consequences and overall economic consequences anticipated by the parties under the law as it existed when the transactions were consummated.

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[3] An identical provision is included in H.R. 3805, the Technical Corrections Act of 1983, introduced by Chairman Rostenkowski. A hearing is scheduled on H.R. 3805 by the Committee on Ways and Means on September 22, 1983.

I respectfully suggest that the Committee consider amending the bill to provide that the new section 267 rules will not apply to interest expenses incurred pursuant to an obligation entered into prior to the introduction of the bill.

Respectfully submitted,

RICHARD L. HUBBARD.

STATEMENT OF MARVIN A. LEVINS, PRESIDENT, GROUP PENSION DIVISION, CONNECTICUT GENERAL LIFE INSURANCE CO., A CIGNA COMPANY

Connecticut General Life Insurance Company, a CIGNA Company, welcomes the opportunity to offer its comments regarding H.R. 3592. The Group Pension Division of CIGNA provides a full range of administrative, underwriting and actuarial services to approximately 7,000 qualified pension and profit-sharing plans covering over 1,000,000 participants, of which approximately 830 plans covering over 20,000 participants have elected to permit participants to make deductible employee contributions to the plan. These participants, however, cannot rollover amounts contributed to and held under an Individual Retirement Account ("IRA") established under Section 408 of the Internal Revenue Code to a plan meeting the requirements of Section 401(a) of the Code ("qualified retirement plan"). Consequently, these participants are forced to continue their IRAs even if they are making deductible employee contributions to their employer's qualified retirement plan. We respectfully urge that the provisions of H.R. 3592 be expanded to permit such rollovers.

Prior to the enactment of the Economic Recovery Tax Act of 1981 ("ERTA"), rollovers from an IRA to a qualified retirement plan were not permitted primarily because a distribution from a qualified retirement plan received favorable tax treatment without subjecting such distributions to the various restrictions applicable to distributions from an IRA. Thus, if an individual could have rolled over amounts from his IRA into his qualified retirement plan, he could have avoided the IRA restrictions and also received favorable tax advantages not otherwise available to IRA participants. However, ERTA created a vehicle within a qualified retirement plan which is subject to essentially the same restrictions as an IRA and which could be used to permit an individual to rollover amounts distributed from an IRA.

Participants in a qualified retirement plan now are permitted to make deductible employee contributions to the plan and the favorable tax treatment otherwise available for distributions from a qualified retirement plan is not applicable to deductible employee contributions. Moreover, distributions of deductible employee contributions from a qualified retirement plan are subject to limits and restrictions virtually identical to those applicable to IRAs.

The only difference of note between the restrictions on distributions from an IRA and from a qualified retirement plan is that distributions from an IRA must commence not later than the close of the taxable year in which the individual attains age 70½. The only comparable restriction on distributions from a qualified retirement plan is that resulting from the Tax Equity and Fiscal Responsibility Act of 1983. Effective January 1, 1984, distributions to a key employee in a top heavy plan must commence not later than the close of the taxable year in which the employee attains age 70½. We recognize that many participants in qualified retirement plans will not be subject to this restriction. However, they will be sjubject to the requirements that the payment of benefits commence in the taxable year in which the individual attains age 70½ or retires, whichever is later. As a practical matter, most of these employees will have retired by the time they attain age 70½. Hence, they will be subject to a comparable restrictions. Those few individuals who have not retired by age 70½ typically will not be able to decide on their own to defer retirement. This decision will be made in conjunction with the employer to further its business needs. Consequently, legal and practical considerations should preclude the deferral of the commencement of benefits beyond age 70½ to avoid current taxation. Under these circumstances, we should not deny individuals the opportunity to consolidate their retirement savings into a program that facilitates good financial planning and management.

CIGNA Corporation urges you to expand the rollover rules to permit an individual who maintains an IRA and wishes to combine it with the balance retained in his qualified retirement plan to do so if the qualified retirement plan will accept deductible employee contributions and the rollover amount is held as a deductible employee contribution.

INVESTMENT COMPANY INSTITUTE,
Washington, D.C., September 28, 1983.

Hon. DAN ROSTENKOWSKI,
Chairman, Committee on Ways and Means, Longworth House Office Building, Washington, D.C.

DEAR MR. CHAIRMAN: The Investment Company Institute [1] welcomes this opportunity to express its strong support for the enactment of section 6 of H.R. 3592. That provision of the legislation would coordinate certain amendments to section 103 of the Internal Revenue Code of 1954, as amended, made by the Highway Revenue Act of 1982 (P.L. 97-424) and Public Law 97-473. Specifically, section 6 provides that Public Law 97-473 shall be deemed to have been enacted immediately before the Highway Revenue Act for purposes of applying the amendments made to Code section 103 by those two laws.

The Institute supports the corrective measure described in section 6 of H.R. 3592 as the appropriate means of clarifying the ambiguity created by the order in which the President signed into law the Highway Revenue Act of 1982 (P.L. 97-424) and Public Law 97-473. It is our understanding that these two bills were drafted by Congress in a manner which contemplated that P.L. 97-473 would be enacted before P.L. 97-424 (the Highway Revenue Act of 1982). However, the President signed the bills into law in the reverse order. As you recognized in your letter to us, corrective legislation would be appropriate to cure any possible technical ambiguity which could result. Section 6 of H.R. 3592 would achieve this result by simply providing that the provisions of the two laws amending Code section 103 be deemed to have been enacted in the manner contemplated by Congress when it drafted these provisions. Thus, section 6 constitutes a technical correction which is necessary to clarify any ambiguity arising with regard to the interpretation of the two laws cited above.

We wish to express our appreciation for the inclusion of section 6 in H.R. 3592 and offer our assistance in supporting its enactment.

Sincerely,

DAVID SILVER, *President.*

LAVENTHOL & HORWATH,
NATIONAL TAX DEPARTMENT,
Washington, D.C., September 22, 1983.

Mr. DAN ROSTENKOWSKI,
Committee on Ways and Means, House of Representatives, Longworth House Office Building, Washington, D.C.

DEAR MR. ROSTENKOWSKI: This letter is to call your attention to one aspect of H.R. 3592, the Minor Tax Equity Improvement Act, specifically section 2 of that Act, Treatment of Certain Transactions between Related Parties. This section provides a particularly unfair and harsh result to taxpayers who entered into long-term financial relationships which were structured in good faith and which were entirely proper at the time they were entered into.

Your measure would amend the related party rules under IRC § 267 so that a payor would be placed on the cash method of accounting for purposes of deducting business expenses and interest owed to a related cash-basis taxpayer. Also, the present law relating to payments by subchapter "S" corporations would be extended to payments by partnerships. The amendments would apply to all business expenses and interest accrued after December 31, 1983 regardless of when the transaction was originally arranged.

It has been stated that the measure was developed "to improve the equity of the tax law". However, that is not the result in certain cases. Our primary concern is with the effective date of the provision. As proposed, it is effective for all expenses accrued after December 31, 1983. Therefore, it could affect partnerships or other entities that have been in existence for many years and that have properly been accruing and deducting interest to a related party. This creates a retroactive effect, i.e., it affects transactions that have been in existence for long periods.

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[1] The Investment Company Institute is the national association of the American mutual fund industry. Its membership includes 884 open-end investment companies ("mutual funds"), their investment adisers and principal underwriters. Its mutual fund members have assets of about $264.5 billion, accounting for approximately 90% of total industry assets, and have approximately 16 million shareholders.

This is not equitable and we believe it is unreasonable to impose this upon entities who have relied upon and properly followed the law in the past.

We suggest that the effective date of these provisions be for transactions entered into after the date of enactment of the bill. This would better improve the equity of the tax law without imposing undue hardships upon entities that entered into proper transactions prior to the imposition of the bill.

Thank you for your consideration.

Very truly yours,

STEVEN F. HOLUB, *Partner*.

STATEMENT OF ALAN J. B. ARONSOHN, TAX COUNSEL, NATIONAL REALTY COMMITTEE, INC.

The National Realty Committee, Inc. is a non-profit business league whose membership includes owners, operators, financiers, and developers of all types of real estate throughout the United States.

The National Realty Committee respectfully submits the following comments with respect to H.R. 3592, particularly as to its amendment of Section 267 of the Internal Revenue Code of 1954, as amended (the "Code").

The National Realty Committee is sympathetic to the concerns that underlie Section 4 of H.R. 3592 but believes that the mechanism by which the bill attempts to address these concerns not only fails in these attempts but also creates a number of disturbing collateral consequences.

Section 4 of H.R. 3592 is apparently meant to address the problem of taxpayers whipsawing the fisc when, due to differing methods of accounting, a taxpayer on one side of a transaction currently accrues a deduction while the taxpayer on the other side of the transaction defers the corresponding recognition of income. The problem created by the Code's failure to take into account the time value of money in such instances has been the topic of some recent discussion on Capitol Hill, such as in a statement by Acting Treasury Tax Legislative Counsel Robert G. Woodward before the Senate Finance Subcommittee on Oversight of the Internal Revenue Service at a hearing on tax shelters held on June 24, 1983 and in a pamphlet prepared by the staff of the Joint Committee on Taxation in connection with the hearing. Section 4 of H.R. 3592 attempts to address this problem by applying the revised rules of Code Section 267 to transactions between a partnership and the owner (actual or by attribution) of any capital of profits interest in the partnership.

The bill's special focus on partnerships rather than on the more basic issue of the Code's failure in many respects to take into account the time value of money will cause its primary effect to be as a trap for the unwary rather than as an obstacle for those seeking to take advantage of the whipsaw potential. It is likely that sophisticated taxpayers seeking such an advantage will be able to structure their transactions so as to avoid the effects of the bill, while the small, unsophisticated taxpayer will not. For example, assume that a partnership on the accrual method of accounting leases property from an individual on the cash method of accounting. The terms of the lease provide for deferral of the payment of some of the rent in the early days to help preserve the lessee's cash flow. If neither the lessor nor any party related to him owns a capital or profits interest in the lessee partnership, the latter can deduct the deferred rent in the year in which it accrues (see Revenue Ruling 70-119, 1970-C.B. 120), while this would not be true under the bill if, for example, the lessor's brother happens to own a one-tenth of one percent capital or profits interest in the lessee partnership. Obviously, sophisticated taxpayers would be sure to have the brother dipose of his interest, while unsophisticated taxpayers might not. There is no rational reason for the tax results of the transaction as to the entire partnership to depend on the existence of the miniscule ownership interest or on the sophistication of the taxpayers involved.[1]

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[1] We note that the inclusion in the Subchapter S Revision Act of 1982 of an amendment to Code Section 267 adding subsection (f) pursuant to which the limitations on deductibility under Section 267 with respect to expenses and interest payable by an S corporation to a direct or indirect shareholder of such corporation were extended to situations in which the shareholder owns as little as 2 percent in value of the outstanding stock. Although we believe that this provision may also be subject to some of the same criticism suggested herein with respect to the extension of Section 267 to partners owning a minor interest in a partnership accruing expenses

Continued

A particularly troubling aspect of the bill's focus on partnerships is the great stress it places on the determination of whether or not a particular co-ownership or joint activity rises to the level of a "partnership", a determination that is often extremely difficult to make. This determination is of little consequence under the current Code Section 267 because the Treasury Regulations under that section treat a partnership as an aggregation of individuals rather than as an equity for purposes of that section. See Treasury Regulation 1.267(b)-1(b). On the other hand, under the bill, the application of Code Section 267 would differ greatly depending on this difficult determination. To illustrate, in the lease example discussed in the previous paragraph, if the lessor's brother owns a one-tenth of one percent capital or profits interest in the lessee partnership, only the brother's deduction of his allocable share of the deferred rent would be denied under current law, whether or not the lessee was actually a partnership for tax purposes. By contrast, under the bill, the deduction for all of the deferred rent would be denied if the lessee is treated as a partnership, while only the deduction of the brother's allocable share would be denied if it is not.

Finally, another important flaw in the bill is that it contains no grandfathering provision whatsoever. It would be grossly unfair to create such a radical change in the tax treatment of transactions entered into before the public had adequate notice of the bill. The bill should exclude from its scope deductions pursuant to binding agreements entered into before the date of the enactment of the bill, or at least before the date of the introduction of the bill.

STATEMENT OF THE UNITED STATES LEAGUE OF SAVINGS INSTITUTIONS

The U.S. League fully supports the concept in H.R. 3592 which would permit rollovers of partial distributions from qualified plans. It has been evident in the past that the limitation on rollover capability to lump sum distributions or plan termination distributions has been inequitable for a number of taxpayers who have been deprived, in most cases through circumstances beyond their control, from continuing tax shelters previously available to them for funds to their credit held in their employers' pension plans. If the tax shelter for these pension funds is lost, we believe the incentive to save the funds for retirement is lost. The proposed change would do much to remedy this problem.

However, while supporting the concept, we recommend that consideration be given to waiving the 50 percent of the balance rule for employees who involuntarily receive a distribution from their employers' pension plans. Such a distribution may be made when a plan is amended or one of two plans maintained by the employer is terminated or amended. The following two examples illustrate situations where the 50 percent requirement may not be satisfied but where the partial rollover should nevertheless be allowed:

(1) A qualified plan providing for nondeductible employee contributions as well as employer contributions is amended retroactively to its inception to be noncontributory. Because of the retroactivity of the amendment, all employee contributions are refunded together with accumulated earnings at a specified arbitrary rate of interest. While the return of the employee contributions themselves has no tax impact, the distributed earnings are considered by the IRS to be taxable to the employee, but ineligible for rollover because the distribution constitutes neither a lump sum distribution nor a plan termination distribution. We believe the proposed rule should be revised to allow continuation of the tax shelter in such a situation by rollover of the taxable portion received into an IRA even if it does not represent 50 percent of the employee's total balance.

(2) Another illustration of a situation where rollover should be permitted is an instance where an employer had a pension plan, discontinued and froze it in a prior year and established a new qualified plan. With just a few long-time employees left who have funds to their credit in the "old" plan, the employer wishes to distribute

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or interest, it should be noted that in the case of S corporations, prior to the 1982 amendments, Section 267 had no application whatsoever unless the cash-basis shareholder (after application of the constructive onwership rules of Section 267(c)) owned more than 50 percent of the stock of the corporation.

The 1982 amendments with respect to such S corporations were necessary, therefore, to create any limitation on the deductibility of accrued expenses and interest between S corporations and shareholders owning 50 percent or less of such corporations' stock. In contrast, in the case of partnerships, Treasury Regulations Section 1.267(b)-1(b) already produces the appropriate result, i.e., disallowance of unpaid accrued expenses and interest to a cash-basis partner to the full extent of such partner's direct and indirect interest in the partnership.

the proceeds of the discontinued plan so as to avoid the book- and record-keeping that the old plan generates. It is believed that the IRS would aggregate the balances in the old plan with the balances in the successor plan for the purpose of determining whether a plan termination distribution occurs, and, of course, for those continuing employment, the distribution would not represent a lump sum distribution and would not represent 50 percent of any recipient's account balance under the proposed amendment.

Consequently, the League recommends that in order to allow rollovers in the foregoing circumstances and in similar circumstances, the 50 percent rule not be imposed where receipt of the distribution is involuntary on the employee's part and the distribution occurs because of an amendment to a plan or other action by an employer, and the funds distributed are not eligible for rollover under any other provision.

Furthermore, because of the nature of the distributions sought to be covered by this proposal, we believe that forfeiture of 10-year averaging on future distribution of balances remaining in employees accounts should not be required under such circumstances.

The League also recommends an addition to H.R. 3592 which is unrelated to the foregoing proposed amendment, but which is significant for any beneficiary of an IRA grantor where such grantor has died in any tax year up to and including 1983.

Applicable Code rules (Sec. 408(a)(7), prior to its amendment by TEFRA) provide that when an IRA grantor dies the funds in his IRA must, within 5 years, be distributed or used to purchase an annuity for the beneficiary for a period not exceeding the beneficiary's life or life expectancy.

Estate tax exclusionary language in the Internal Revenue Code recognizes that the exclusion is allowed where the distribution is made pursuant to an annuity "or other arrangement" where the funds are payable over a period of 36 months or longer.

The IRS itself issued several private letter rulings stating that direct payment over a period certainly not exceeding beneficiary life expectancy constituted an annuity.

With no other official interpretation being issued by the IRS and certainly nothing stated to the contrary, IRA beneficiaries entitled to receive death benefits concluded that their direct payout arrangements entered into between the financial institution and the beneficiary satisfied the statutory requirement. Consequently, many such payout arrangements have been established in the years since 1975 when IRAs first were authorized.

Recently, however, IRS published a General Counsel's Memorandum (No. 38991) which took a position totally contrary to IRS's previous position.

This places in jeopardy the tax situations of many beneficiaries reaching payout status in any year through 1983. (Under TEFRA, of course, the "annuity" option will not be available for the beneficiaries of IRA grantors dying after 1983.)

We believe that the tax status of beneficiaries who have elected direct periodic payout from their IRAs over a period certain should be protected and that they should be taxable only on the amounts they have received under such arrangement, and that they should continue to be taxed only as the funds are distributed to them under the periodic schedule.

The League, therefore, recommends adoption of an amendment recognizing that direct payout on a periodic basis from the financial institution holding the IRA constitutes an annuity for purposes of applying section 408(a)(2) of the Internal Revenue Code as it read prior to its amendment by P.L. 97-248.

This is desirable because:

(1) It represents little or no measurable revenue loss.

(2) It protects innocent taxpayers against the harsh retroactive effect of an adverse interpretation issued without prior notice on an issue as to which the IRS had provided no public guidance, and in fact, taken a favorable position in response to requests for private letter rulings from taxpayers and financial institution trustees.

(3) It prevents needless shifting of stable retirement savings from home mortgage lending institutions which for years have provided periodic payouts from IRAs for retirement purposes.

The U.S. League appreciates the opportunity to present its views on H.R. 3592 and related IRA issues.

I

98TH CONGRESS
1ST SESSION

H. R. 3593

To amend the Internal Revenue Code of 1954 to allow the medical care deduction for lodging away from home in certain cases.

IN THE HOUSE OF REPRESENTATIVES

JULY 19, 1983

Mr. STARK (for himself and Mr. CONABLE) introduced the following bill; which was referred to the Committee on Ways and Means

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A BILL

To amend the Internal Revenue Code of 1954 to allow the medical care deduction for lodging away from home in certain cases.

Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled,

SECTION 1. MEDICAL CARE DEDUCTION ALLOWED FOR LODGING AWAY FROM HOME IN CERTAIN CASES.

(a) IN GENERAL.—Subsection (d) of section 213 of the Internal Revenue Code of 1954 (relating to definitions for purposes of the deduction for medical, dental, etc., expenses) is amended by redesignating paragraphs (2), (3), (4), (5), and

(6) as paragraphs (3), (4), (5), (6), and (7), respectively, and by inserting after paragraph (1) the following new paragraph:

"(2) AMOUNTS PAID FOR CERTAIN LODGING AWAY FROM HOME TREATED AS PAID FOR MEDICAL CARE.—Amounts paid for lodging (not lavish or extravagant under the circumstances) while away from home primarily for and essential to medical care referred to in paragraph (1)(A) shall be treated as amounts paid for medical care if—

"(A) the medical care referred to in paragraph (1)(A) is provided by a physician in—

"(i) a licensed hospital, or

"(ii) a nationally or regionally recognized medical care facility substantially all the services provided by which are medical care services, and

"(B) there is no significant element of personal pleasure, recreation, or vacation in the travel away from home."

(b) TECHNICAL AMENDENT.—Paragraph (6) of section 213(d) of such Code, as redesignated by subsection (a), is amended by striking out "paragraph (2)" and inserting in lieu thereof "paragraph (5)".

(c) Effective Date.—The amendments made by this section shall apply to taxable years beginning after December 31, 1983.

Summary and Description

PRESENT LAW

As a general rule, individuals who itemize deductions may deduct expenses paid during the taxable year, not compensated for by insurance or otherwise, for medical care of the taxpayer, the taxpayer's spouse, or a dependent, to the extent that such expenses exceed 5 percent of adjusted gross income (Code Sec. 213). The term medical care is defined to include amounts paid for: (1) the diagnosis, cure, mitigation, treatment, or prevention of disease, or for the purpose of affecting any structure or function of the body; (2) transportation primarily for and essential to such medical care; and (3) insurance covering medical care. The primary rationale for allowing an itemized deduction for medical expenses is that "extraordinary" medical costs reflect an economic hardship, beyond the taxpayer's control, which reduces the taxpayer's ability to pay Federal income tax.

EXPLANATION OF THE BILL

Under the bill, the definition of medical care provided in section 213(d) would be broadened to include amounts paid for lodging while away from home under circumstances in which such lodging is primarily for and essential to medical care provided by a physician in (1) a licensed hospital or (2) a nationally or regionally recognized medical care facility. The deduction would not be allowed for amounts paid for lodging that is lavish or extravagant under the circumstances. Further, no deduction would be allowed if there is a significant element of personal pleasure, recreation, or vacation in the travel away from home.

EFFECTIVE DATE

The provisions of the bill would apply to taxable years beginning after December 31, 1983.

REVENUE EFFECT

The revenue effect of this bill is not available at this time.

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98TH CONGRESS
1ST SESSION

H. R. 4206

To amend the Internal Revenue Code of 1954 to exempt from Federal income taxes members of the Armed Forces of the United States who die as a result of hostile actions overseas.

IN THE HOUSE OF REPRESENTATIVES

OCTOBER 25, 1983

Mr. ARCHER introduced the following bill; which was referred to the Committee on Ways and Means

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A BILL

To amend the Internal Revenue Code of 1954 to exempt from Federal income taxes members of the Armed Forces of the United States who die as a result of hostile actions overseas.

Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled,

SECTION 1. INCOME TAXES OF MEMBERS OF ARMED FORCES ON DEATH.

(a) GENERAL RULE.—Section 692 of the Internal Revenue Code of 1954 (relating to income taxes of members of Armed Forces on death) is amended by adding at the end thereof the following new subsection:

"(c) MEMBERS OF ARMED FORCES DYING AS RESULT OF HOSTILE ACTIONS OVERSEAS.—In the case of any individual who dies while in active service as a member of the Armed Forces of the United States, if such death occurs as a result of wounds, disease, or injury incurred as a result of a hostile action outside the United States—

"(1) any tax imposed by this subtitle shall not apply with respect to the taxable year in which falls the date of his death, or with respect to any prior taxable year ending on or after the first day he so served outside the United States, and

"(2) any tax under this subtitle for taxable years preceding those specified in paragraph (1) which is unpaid at the date of his death (including interest, additions to tax, and additional amounts) shall not be assessed, and if assessed the assessment shall be abated, and if collected shall be credited or refunded as an overpayment.

The preceding sentence shall not apply to the extent that subsection (a) applies to the individual."

(b) EFFECTIVE DATE.—The amendment made by subsection (a) shall apply with respect to all taxable years (whether beginning before, on, or after the date of the enactment of this Act) of individuals dying after December 31, 1979.

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SUMMARY AND DESCRIPTION

PRESENT LAW

Under present law, military personnel who die while serving in a combat zone, or as a result of wounds, disease, or injury incurred while serving in a combat zone, are exempt from Federal tax on income for the year of death and for any prior year ending on or after the first day such individual served in a combat zone (Code sec. 692(a)). The Congress has delegated the designation of "combat zones" to the President (sec. 112(c)(2)).[1]

In addition, if a serviceperson is reported in a missing status or a number of years, and it is subsequently determined that he or she actually died at an earlier time, there is no tax on income for years after the year of actual death. This exclusion for individuals who were in a missing status applies to the year of death and to years after death that precede and include the year of determination of death, but only for years beginning (1) on or before December 31, 1982, in the case of the combat zone designated for purposes of the Vietnam conflict,[2] or (2) within two years after termination of any other combat zone designation (sec. 692(b)).

PRIOR LEGISLATION

In 1970, the Congress enacted legislation treating individuals who had been removed from U.S. vessel and who died while being illegally detained by the Democratic People's Republic of Korea during 1968 as serving in a combat zone (P.L. 91-235). Thus, service personnel who were members of the crew of the U.S.S. *Pueblo*, illegally detained in 1968 by North Korea, and who died during the detention were eligible for the income tax exclusion (and other special tax rules) available for service personnel who die in combat zones.

Under legislation enacted in 1980, if any American hostage held captive in Iran between November 4, 1979 and December 31, 1981 died as a result of injury or disease or physical or mental disability incurred or agravated while in captive status, any income taxes imposed by the Code would not have applied with respect to the year in which the individual died or any prior year ending on or after the first day the individual was in captive status (sec. 202 of P.L. 96-449). This treatment would have applied to military and civilian personnel of the United States and to certain other individuals, as well as to certain other U.S. taxpayers taken captive outside Iran on or before December 31, 1981. Moreover, if there had been any unpaid income tax liability of such an individual from years prior to captivity, the liability would have been forgiven. This total income tax exemption for American hostages who die as a result of captive status would have been available only if death had occurred within two years after the individual ceased to be in captive status.

EXPLANATION OF THE BILL

The bill would provide special income tax rules for certain individuals who die while in active service as a member of the Armed Forces of the United States.

If death occurs from wounds, disease, or injury incurred as a result of a hostile action outside the United States, then no U.S. income tax would apply for the year of death or for any earlier year ending on or after the first day the individual served outside the United States. In addition, any U.S. income tax for years preceding the year of first service outside the United States which is unpaid at the date of death (including interest, additions to tax, and additional amounts) would not be assessed. (If assessed, the assessment would be abated, and if collected, the liability would be credited or refunded as an overpayment.)

The rules of the bill would not apply to the extent that the combat zone rules of current law apply to the individual.

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[1] Presidential designation of a combat zone entails other Federal tax consequences, including (1) exclusion from gross income of certain amounts of military pay of personnel serving there (sec. 112), (2) reduced estate taxes for personnel dying as a result of service there (sec. 2201), and (3) postponement of deadlines for filing returns, paying tax, and performing other acts for personnel serving their (sec. 7508).

[2] Vietnam became a combat zone as of January 1, 1964.

EFFECTIVE DATE

The bill would apply with respect to all taxable years (whether beginning before or after the date of the enactment of the bill) of individual dying after December 31, 1979.

THE AMERICAN LEGION,
Washington, D.C., November 8, 1983.

Hon. FORTNEY H. STARK,
Chairman, House Ways and Means, Subcommittee on Select Revenue Measures, Longworth House Office Building, Washington, D.C.

DEAR CHAIRMAN STARK: The American Legion would like to take this opportunity to applaud your decision to consider H.R. 4206. As you know this bill will provide a small measure of relief for the families of servicemen killed as a result of hostile action overseas and carries our enthusiastic support.

The Legion believes that H.R. 4206 is not only an appropriate action but also a necessary one for the families of those who have died in service to their country. The enactment of this measure will benefit both families of those who have service as well as the morale and peace of mind of those who continue to serve under such trying conditions.

We urge you, Chairman Stark, and members of your Subcommittee to act expeditiously on this matter. As always, The American Legion thanks you for your consideration of its views and requests that this letter be included in the record of these proceedings.

Sincerely,

KEITH KREUL, *National Commander.*

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98TH CONGRESS
1ST SESSION

H. R. 4253

To allow claims for credit or refund for transportation expenses incurred with respect to employment at the antiballistic missile site near Nekoma, North Dakota.

IN THE HOUSE OF REPRESENTATIVES

OCTOBER 31, 1983

Mr. DORGAN introduced the following bill; which was referred to the Committee on Ways and Means

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A BILL

To allow claims for credit or refund for transportation expenses incurred with respect to employment at the antiballistic missile site near Nekoma, North Dakota.

Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled, That (a) employment at the antiballistic missile project near Nekoma, North Dakota, shall be treated for purposes of sections 62 and 162 of the Internal Revenue Code of 1954 as temporary employment with respect to transportation and traveling expenses—

(1) otherwise allowable as a deduction under section 162(a) of such Code,

(2) paid or incurred after 1969 and before 1975, and

(3) claimed on a return filed for any taxable year which includes any portion of the period described in paragraph (2).

(b) If refund or credit of any overpayment of Federal income tax resulting from the application of subsection (a) is prevented at any time before the date one year after the date of the enactment of this Act by the operation of any law or rule of law (including res judicata), refund or credit of such overpayment (to the extent attributable to the application of subsection (a)) may, nevertheless, be made or allowed if claim therefor is filed before the date one year after the date of the enactment of this Act.

(c) This Act shall apply to taxable years ending after December 31, 1969.

SUMMARY AND DESCRIPTION

PRESENT LAW

Present law allows a deduction for all ordinary and necessary expenses paid or incurred in carrying on a trade or business (Code sec. 162). Traveling expenses which meet these general requirements are deductible if incurred while away from home in the pursuit of a trade or business. For these purposes, traveling expenses include transportation fares as well as amounts expended for meals and lodging, other than amounts which are lavish or extravagant under the circumstances (sec. 162(a)(2); Treas. Reg. sec. 1.162-2(a)).

Traveling expenses are considered to be incurred while away from home in several different situations. One such situation is when the traveling expenses are incurred in connection with temporary employment and the taxpayer has a regular or principal place of business (or, in its absence, a regular place of abode) away from which the temporary employment takes place. The term temporary for this purpose generally is defined by the Internal Revenue Service and the majority of courts to mean employment which can reasonably be expected to last only for a short period of time. By contrast, traveling expenses incurred in connection with employment which is considered to be of indefinite or indeterminate duration generally are not deductible. On numerous occasions, the courts have considered the issue of whether a particular taxpayer's employment is temporary or indefinite in nature.[1]

In a 1979 case, *Frederick* v. *United States,*[2] the U.S. Court of Appeals for the Eight, Circuit upheld the District Court's ruling that a taxpayer's employment as a carpenter at an anti-ballistic missile project in Nekoma, North Dakota, during the years 1970 through 1973, was temporary and, therefore, that the taxpayer's associated transportation expenses were deductible. The District Court had reasoned that because of the seasonal nature of the employment and numerous lay-offs during construction, the taxpayer had reasonably expected to be employed on the project for a temporary period only. The Internal Revenue Service has stated that it will not follow the *Frederick* decision outside the Eight Circuit.[3]

EXPLANATION OF THE BILL

The bill would provide a general statutory rule for the income tax treatment of certain traveling and transportation expenses incurred in connection with employment at the anti-ballistic missile project near Nekoma, North Dakota.

Under the bill, employment at the Nekoma anti-ballistic missile project would be treated as temporary, for purposes of the business deduction rules, with respect to transportation and traveling expenses meeting three requirements. These requirements are: (1) the expenses are otherwise deductible as a business expense under Code section 162(a); (2) the expenses were paid or incurred after 1969 and before 1975; and (3) the expenses were claimed on a tax return filed for any taxable year which includes any portion of the period described in (2).

If these requirements are satisfied, traveling and transportation expenses incurred in connection with employment at the Nekoma anti-ballistic missile project would be deductible under the business deduction rule permitting the deduction of certain expenses incurred in connection with temporary employment.

In addition, the bill would permit taxpayers who would be entitled as a result of its provisions to a credit of any overpayment or refund, but for the operation of another law or rule of law (including res judicata), to obtain the credit or refund by filing a claim for it within one year after the date of enactment.

EFFECTIVE DATE

The bill would apply retroactively to taxable years ending after 1969, with respect to expenses paid or incurred after 1969 and before 1975.

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[1] See, e.g., *Peurifoy* v. Commissioner, 358 U.S. 59 (1958); *Kasun* v. *United States,* 671 F. 2d 1059 (7th Cir. 1982); *Clark* v. *Commissioner,* 46 T.C.M. 964 (1983); *Blankenship* v. *Commissioner,* 39 T.C.M. 91 (1979). See also Rev. Rul. 83-82, I.R.B. 1983-22, 5; Rev. Rul. 60-189, 1960-1 C.B. 60.

[2] 79-2 U.S.T.C. Para. 9529 (8th Cir. 1979), *aff'g* 78-2 U.S.T.C. Para. 9774 (N.D. 1978).

[3] Rev. Rul. 80-333, 1980-2 C.B. 60.

I

98TH CONGRESS
1ST SESSION

H. R. 4271

To amend the Internal Revenue Code of 1954 to increase the limitation on the deduction for business gifts from $25 to $100.

IN THE HOUSE OF REPRESENTATIVES

NOVEMBER 1, 1983

Mr. ROSTENKOWSKI introduced the following bill; which was referred to the Committee on Ways and Means

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A BILL

To amend the Internal Revenue Code of 1954 to increase the limitation on the deduction for business gifts from $25 to $100.

Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled, That (a) paragraph (1) of section 274(b) of the Internal Revenue Code of 1954 (relating to limitation on deduction for business gifts) is amended by striking out "$25" and inserting in lieu thereof "$100".

(b) The amendment made by subsection (a) shall apply to gifts made after the date of the enactment of this Act in taxable years ending after such date.

SUMMARY AND DESCRIPTION

PRESENT LAW

Code section 274(b) generally disallows business deductions for gifts to the extent that the total cost of all gifts of cash, tangible personal property, etc., to the same individual from the taxpayer during the taxable year exceeds $25. The statute expressly defines the term "gift" to mean any amount excludable from gross income under section 102 (relating to gifts and bequests).

The $25 limitation is increased in the case of business gifts of items of tangible personal property which are awarded to employees for certain purposes. Prior to enactment of the Economic Recovery Tax Act of 1981 (ERTA), this exception to the general $25 limitation applied to an item of tangible personal property only if the items's cost did not exceed $100, and only if the item was awarded to an employee by reason of length of service or for safety achievement.

ERTA increased the ceiling on deductions for business gifts to employees of items of tangible personal property in one year from $100 to $400 of cost for an item of tangible personal property which is awarded to an employee for the purposes specified in the statute. Also, ERTA expanded those purposes to include productivity, as well as length of service and safety achievement. Under these rules, a deduction is allowed up to $400 of cost of an item the cost of which exceeds $400.[1]

BACKGROUND

Section 102 exclusion for gifts

Under Code section 102, gross income does not include the amount of cash, or the value of property, received by an individual as a gift. The U.S. Supreme Court has long held that this exclusion does not apply to property received in a business or commercial context if the item is intended as additional compensation for past or future services, regardless of whether the payor and recipient designate the transfer as a "gift" (e.g., *Comm'r* v. *LoBue,* 351 U.S. 243 (1956)).

In the leading case involving payments made "in a context with business overtones" (*Comm'r* v. *Duberstein*), the Supreme Court stated as follows with respect to distinguishing excludable gifts from includible compensation:

"* * * (A) voluntary executed transfer of * * * property * * *, without any consideration or compensation therefor, though a common-law gift, is not necessarily a 'gift' within the meaning of the (income tax) statute. For the Court has shown that the mere absence of a legal or moral obligation to make such a payment does not establish that it is a gift.* * * And, importantly, if the payment proceeds primarily from the 'constraining force of any moral or legal duty,' or from 'the incentive of anticipated benefit' of an economic nature * * *, it is not a gift. And, conversely, '(w)here the payment is in return for services rendered, it is irrelevant that the donor derives no economic benefit from it.' "[2]

Under *Duberstein,* the determination of whether property transferred from an employer to an employee (or otherwise transferred in a business context) constitutes a gift to the recipient is to be made on a case-by-case basis, by an "objective inquiry" of the facts and circumstances. If the transferor's motive was "the incentive of anticipated benefit," or if the payment was in return for services rendered (whether or not the payor received an economic benefit from the payment), then the payment must be included in income by the recipient.[3]

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[1] In addition, the amount of the allowable deduction for such business gifts was further increased by ERTA in cases where the item of tangible personal property is awarded for the specified purposes as part of a permanent, written plan or program of the taxpayer that does not discriminate in favor of officers, shareholders, or highly compensated employees as to eligibility or benefits.

A deduction is allowed for such plan awards of tangible personal property only if the average cost of all awards under all such plans of the taxpayer during the taxable year does not exceed $400. In addition, no deduction may be claimed under such an award plan or program for a particular item of tangible personal property awarded to an employee for such purposes to the extent that the cost of the item exceeds $1,600.

[2] 363 U.S. 278 (1960). In the *Duberstein* case, the Supreme Court upheld a Tax Court decision that an automobile given to the taxpayer by a business acquaintance was not excludable from income as a gift where the car was intended as remuneration for services rendered, even though there was no prior arrangement for compensation and the individual did not expect to be paid.

Section 274(b) limitation on deduction

Section 274(b) generally limits to $25 the amount deductible (either as business or investment expenses) "for any expense for gifts made directly or indirectly to any individual * * *." For this purpose, the statute expressly defines the term gift to mean "any item excludable from gross income of the recipent under section 102, which is not excludable from his gross income under any other provision" of the tax statute, subject to certain exceptions. Thus, section 274(b) comes into play in the case of a payment of cash or property which section 102 treats as a gift, and provides rules for whether such payments may still be deductible by the payor even though the equation is then "unbalanced," i.e., where a deduction to the payor is not fully matched by income to the recipient.

Section 274(b) was enacted by the Revenue Act of 1962. As passed by the House, the 1962 tax bill would have disallowed any deduction for business gifts exceeding $25 per recipient; there was no exception to this disallowance rule under the House bill for gifts of tangible personal property. The Senate Finance Committee amended the provision to add three exceptions to the $25 limitation, including an exception for an item of tangible personal property having a cost to the taxpayer (employer) not in excess of $100 if awarded to an employee by reason of length of service or safety achievement. The Finance Committee report on the 1962 bill states that this exception for certain business gifts of tangible property "relates only to deductibility by the employer" and "is not intended to have any effect in determining whether the employee who receives the award is to be taxed on its value."[4]

As described above, ERTA increased the ceiling on deductions for certain business gifts to employees of items of tangible personal property and expanded the purposes for which such gifts eligible for the increased deduction may be awarded to include productivity, as well as length of service and safety achievement. The legislative history of the ERTA provision, which was added to the bill by Senate floor amendment, reflects an intent to increase the original $100 tangible personal property deduction limit in view of the effect of inflation in the 20 years subsequent to enactment of that provision.[5]

EXPLANATION OF THE BILL

The bill would amend Code section 274(b) by increasing from $25 to $100 the general limitation on the deductibility under section 162 or 212 of all gifts of cash and property made to the same individual from the taxpayer during the taxable year. The amendment would not modify the exceptions to the general limitation which are enumerated in the statute (e.g., the special limitation on deductibility of gifts of certain tangible personal property awarded to employees for the specified purposes).

EFFECTIVE DATE

The amendment made by the bill would apply to gifts made after the date of enactment of the bill.

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[3] Under the *Duberstein* test, for example, the Tax Court has held that bonus payments made by an aircraft manufacturer to distributors based on the number of aircraft sold through their distributorships are not excluded from income as gifts, even though the manufacturer did not claim a business deduction for such payments, since the effect of the payments "was as an 'incentive of anticipated benefit of an economic nature' " (*Hodge* v. *Comm'r*, 32 CCH Tax Ct. Mem. 277, 283 (1973)).

[4] Sen. Rpt. No. 1881, 87th Cong., 2d Sess. 171 (1962).

[5] See 127 Cong. Rec. S-8640 (daily ed. July 28, 1981) (remarks of Senators Garn and Dole); Staff of Jt. Comm. on Taxation, 97th Cong., 1st Sess., General Explanation of the Economic Recovery Tax Act of 1981 179-180 (Comm. Print 1981).

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